Down the Rabbit-Hole and into the Nineties: Issues of Accountability in the Wake of Eighties-Style Transactions in Control

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Introduction

In Alice's Adventures in Wonderland, the eponymous heroine, in pursuit of the dapper White Rabbit, descended the Rabbit-Hole, "never once considering how in the world she was to get out again."1 Not too long thereafter, Alice reflected that "so many out-of-the-way things had happened lately, . . . that very few things indeed were really impossible."2

Events in the 1980s produced a number of corporations that now have controlling shareholders who often acquired their control through hostile tender offers, levered buyouts (LBOs), or leveraged recapitalizations.3 Following the transaction, directors evidently are accountable to the newly installed controlling

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2. Id. at 10.
shareholder with the exception of holdover directors whose terms have yet to expire and who resist the new regime in the wake of a hostile transaction. Like Alice down her Rabbit-Hole, however, we should not assume that "very few things [are] really impossible." For down this particular corporate Rabbit-Hole lurk many questions of accountability, some of them distinctive to post-transaction relationships, including directors' accountability to shareholders and the controlling shareholder's duty to other shareholders as well as to creditors of the corporation.\(^4\)

This Article examines selected problems of accountability arising in the wake of highly leveraged transactions in corporate control that occurred in the 1980s; it focuses primarily on the conduct of controlling shareholders and directors that may appear problematic and cause serious harm to the interests of the corporation's other shareholders or its creditors. This Article argues that the organizational innovations engendered by these corporate control transactions, although desirable in some respects, are susceptible to the risk that controlling shareholders will breach their fiduciary duty to other shareholders and engage in opportunistic conduct that harms other shareholders and creditors.

In addition, relationships among shareholders are not always harmonious following transactions in corporate control. Down the Rabbit-Hole, in short, reside distinctive species of familiar problems. In this setting, this Article explores relevant provisions of the American Law Institute's (ALI) *Principles of Corporate Governance (Principles)*, particularly those provisions defining limits on the prerogatives of controlling shareholders, and those regulating derivative litigation. The Article concludes that these provisions are inconsistent and do not mesh together successfully. As a result, they are not likely to contribute much, beyond the content of present law, to resolving disputes focused on the conduct of controlling shareholders.

Part I of this Article discusses the problem of director accountability to shareholders and the corporate law devices that enforce this accountability. Part II presents basic patterns of conflict that arise when a new shareholder obtains control over a corporation and demonstrates that leveraged change-in-control transactions may eliminate conflicts between managers and owners, but do not necessarily ensure harmony among all corporate groups. Part II then examines the duty of controlling shareholders and aspects of derivative litigation under the *Principles*; it concludes that the ALI

\(^4\) Although an examination of the role of institutional investors is beyond the scope of this Article, similar questions of accountability may follow the consolidation of increasingly aggressive institutional shareholders into groups capable of exercising intimidation—if not control—in relationships with corporate directors.
formulations treat inconsistently the credibility and responsibility of disinterested directors. Finally, this Part contrasts the Principles with Delaware law and uses Delaware case law to demonstrate that the ALI approach is internally inconsistent. Part III examines the risk that, after a highly leveraged transaction, a controlling shareholder will act opportunistically at the expense of creditors—a critical problem that the Principles do not address.

I. Ensuring the Accountability of Directors to Shareholders

Ensuring the accountability of directors to shareholders has long been a central challenge for the institutions of corporate law. Legal institutions operate in a context that includes a number of relevant market mechanisms in addition to shareholders. Directors and senior executives are actors in markets for labor that, in general and over time, penalize members who are faithless, hapless, or inept.5 Corporations themselves are actors in competitive markets for outputs of products and services.

Much of the relevant legal framework has evolved from the basic premise that directors are not shareholders’ agents. To be sure, directors are fiduciaries toward the corporation and its shareholders; but the legal definition of agency requires, additionally, that an agent undertake to act subject to the principal’s control.6 Corporate law, though, conventionally confers on directors, once elected, discretionary authority to manage the corporation or, subject to the directors’ ultimate scrutiny, to select managers who will actively run its business. The discretionary and ultimate nature of the authority of directors is inimical to an agency relationship between directors and shareholders.

In addition, a controlling shareholder is itself a fiduciary—a long-established principle in United States law that significantly shapes permissible dealings between a controlling shareholder and the corporation or its other shareholders. In general, if a controlling shareholder causes the corporation to transact on terms that produce a benefit for it to the detriment or exclusion of the corporation’s other shareholders, the controlling shareholder has the burden of establishing the “entire fairness” of the transaction.

Corporate law in the United States at present either creates directly, or facilitates indirectly, a number of devices that, in the absence of an agency relationship, enhance directors’ accountability to shareholders. The strength of these devices has varied over time. English company-law cases set a low-water mark in the nineteenth century by holding that shareholders who elected utterly inept and inattentive directors had no remedy of any sort when the directors’

6. Restatement (Second) of Agency § 1 (1957).
deficiencies led to great loss. The courts reasoned that shareholders, by electing any director, assumed the risk that the director might perform poorly.

At present, corporate law creates or facilitates three devices that enhance accountability. First, to degrees that vary over time, corporate law creates a market for corporate control. Proponents who argue that this market is effective stress that managerial underperformance often leads to business loss for the corporation and thence to a decline in the price at which its shares trade. At such a price, all or a majority of the shares may be an attractive investment to someone with access to sufficient cash or other consideration to buy the shares and replace the corporation's incumbent management. This scenario also may operate prospectively by concentrating managers' and directors' minds on enhancing shareholder value and, relatedly, share price. The vitality of the market in corporate control, however, depends heavily on the availability of financing for transactions in control, which is highly variable over time.

Second, shareholders vote to elect directors and to approve or disapprove fundamental transactions endorsed by directors. In public companies, the SEC's proxy rules provide a federal law framework in which shareholders exercise their franchise. The SEC has recently expended much effort in reconfiguring aspects of the proxy rules to enable shareholders in large corporations to cast informed votes. To a significant extent, the reforms also liberate many communications by and among large shareholders from the strictures of the proxy rules, which may in turn enhance large shareholders' leverage to jawbone management.

7. See Turquand v. Marshall, 4 L.R.-Ch. 376, 386 (App. 1869).
8. Id.
11. See id.
13. See Regulation of Communications Among Shareholders, Exchange Act Release No. 31,326 [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,051 (Oct. 16, 1992). In particular, the new rules create an exemption from otherwise applicable disclosure rules and from the requirement that a proxy statement accompany a communication to shareholders if the person soliciting the vote is not seeking proxy authority and does not have a substantial interest in the matter subject to a vote. See 17 C.F.R. § 240.14a-2(b). The new rules also redefine "solicitation" narrowly to specify that a shareholder may publicly announce how it intends to vote and its reasons for so voting without complying with the proxy rules. See id. § 240.14a-1(f). Likewise, communications among shareholders are furthered by the SEC's longstanding rule mandating the inclusion of certain shareholder proposals in the corporation's proxy statement. See id. § 240.14a-8.
The third corporate law device that facilitates accountability is the derivative suit. Directors who breach the duties that they owe to the corporation may be held accountable, typically after the breach has occurred and its consequences have ensued, through a derivative suit brought by a representative shareholder as plaintiff. If the duties in question are owed directly to individual shareholders, the shareholder does not need to bring the action as a derivative suit. In some settings, the risk of liability also operates prospectively to discourage problematic conduct.15

The operation of all three of these devices is facilitated by rules mandating the disclosure of information in standardized formats so that it is susceptible to comparison. Corporations subject to the periodic reporting requirements imposed by the Securities Exchange Act of 193416 must disclose extensive information about the financial results of their operations. Additionally, they must annually disclose much other information, including the compensation of their five most highly compensated employees,17 as well as the terms of specific types of self-dealing transactions.18

Eighties-style transactions in control illustrate that serious problems of accountability may arise in the aftermath of a shift in control. The existence of a market in corporate control alone does not seem to eliminate the risk of post-transaction conduct that abuses the interests of noncontrolling investors and creditors.

II. Conflicts Among Shareholders

Many scholars are optimistic about the consequences of creating or installing a new controlling shareholder, especially through transactions that involve an acquisition of shares from public shareholders.19 The new controlling shareholder has good reason to


Outside the realm of corporations with publicly traded shares, the franchise matters as well to an investor who acquires voting control, often, but not always, by acquiring a majority of the shares. Even if the corporation has cumulative voting, over time a majority shareholder will be able to elect a majority of directors. In closely held corporations, unless the shareholders agree otherwise, the corporate law norm is that directors exclusively possess management authority. _See generally_ F. Hodge O'Neal & Robert B. Thompson, O'Neal's Close Corporations §§ 5:20-27 (3d ed. 1987) (discussing desirability of shareholder agreements respecting directors' prerogatives).

15. _See, e.g._, Citron v. E.I. Du Pont de Nemours & Co., 584 A.2d 490, 493 (Del. Ch. 1990) (noting parent corporation's knowledge that litigation challenging its acquisition of minority interest in subsidiary was "highly likely": parent did not formulate merger terms itself, but retained an investment banking firm to recommend terms without constraint, and made merger expressly subject to approval by a majority of the minority shareholders).


monitor the performance of the corporation's managers and to install compensation systems designed to align the managers' incentives with shareholder interests.\textsuperscript{20} If the controlling shareholder acquired its interest through a debt-financed acquisition, agents of the lender will also monitor the financial results of firm management.\textsuperscript{21} Finally, the corporation's need to generate cash to make interest payments and repay principal will discourage waste and pursuit of ill-conceived projects within the corporation.

In many transactions, this optimism proves to have been well-founded.\textsuperscript{22} In others, however, the controlling stockholder's actions were problematic, enabling the stockholder to benefit itself to the exclusion or detriment of noncontrolling stockholders.\textsuperscript{23} Separately, the controlling shareholder's interests are not identical to those of the corporation's creditors. The controlling shareholder itself, or directors under its control, may take actions that creditors believe unduly jeopardize their interests.\textsuperscript{24}

\textbf{A. Basic Patterns of Conflict}

The allegations in \textit{Heineman v. Datapoint Corp.},\textsuperscript{25} a derivative suit, illustrate well the potential for post-transaction conflicts among shareholders. In 1985, having earlier acquired in excess of ten percent of Datapoint's stock through two investment partnerships,

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\item 20. \textit{Id.}
\item 21. See Easterbrook & Fischel, supra note 10, at 114.
\item 22. See Anders, supra note 3. Observers whose perspective is macroeconomic, however, doubt the overall contribution of such transactions. Professor Alfred D. Chandler, Jr., concludes his magisterial comparative study of large industrial enterprises by cautioning that some recent highly leveraged transactions "encouraged short-term gains ... at the expense of maintaining long-term [firm] capabilities and profits, [and thereby] reduced and even destroyed the capabilities essential to compete profitably in national and international markets." \textsc{Alfred D. Chandler, Jr., Scale and Scope: The Dynamics of Industrial Capitalism} 627 (1990). As evidence, Chandler cites the rapid decline, after the 1960s boom in merger and acquisition activity, of capital-intensive industries in the United States. \textit{Id.} Other observers are more sanguine, noting that LBO targets tend to be in industries that are not research and development intensive, and that those LBO targets that are involved in research and development tend to be so at an intensity below the industry average. See Frank R. Lichtenberg & Donald Siegel, \textit{The Effects of Leveraged Buyouts on Productivity and Related Aspects of Firm Behavior}, 27 J. Fin. Econ. 165, 187-93 (1990). The same authors report that firms that change owners appear to reduce employment of auxiliary-establishment employees relative to production-establishment employees. Auxiliary establishments are devoted to managing, administering, servicing, or supporting the activities of a firm's other components. See Frank R. Lichtenberg & Donald Siegel, \textit{The Effect of Ownership Changes on the Employment and Wages of Central Office and Other Personnel}, 35 J. Law & Econ. 383, 390, 407 (1990). A reduction in auxiliary-establishment employment, all other factors being held constant, means that the firm produces the same output at lower overhead cost.
\item 23. Whether the risk of such conduct increases as the proportion of shares owned by the controlling shareholder decreases is an intriguing—albeit unanswered—empirical question.
\item 24. For a discussion of how these interests diverge, see infra Part III.
\item 25. 611 A.2d 950 (Del. 1992).
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Asher Edelman offered to buy Datapoint. Rebuffed by Datapoint’s board of directors, Edelman announced that he might solicit shareholder consents to remove the incumbent board and elect his own candidates. The board, in response, adopted a bylaw regulating the timing and efficacy of shareholder action by written consent. The Delaware Supreme Court enjoined enforcement of the bylaw, holding it invalid because it “intrude[d] upon fundamental stockholder rights guaranteed by statute”—specifically, with the provision in the Delaware corporation statute validating shareholder action by written consent. Following a settlement of the litigation challenging the bylaw, Edelman and four other individuals were appointed to Datapoint’s board; collectively, they comprised a majority of the board’s members. At the time of the transactions challenged in Heineman, Edelman was alleged to own approximately fifteen percent of Datapoint’s outstanding shares of common stock.

The plaintiffs in Heineman alleged that Edelman, with the assent of Datapoint’s other directors, caused the corporation to enter into four separate transactions beneficial to him that constituted self-dealing by the directors and a waste of Datapoint’s assets. In particular, the Edelman cohort of directors purportedly caused the corporation: To reimburse them for expenses associated with their battle to attain control of Datapoint and for expenses incurred in developing an ultimately abandoned proposal for an LBO of Datapoint; to place $20 million of Datapoint’s cash in an arbitrage pool accessible to partnerships in which directors had interests; to approve an agreement for $300,000 in consulting services to be furnished to Datapoint, a computer company, by an Edelman-controlled stockyard company; and to approve a $245,000 fee for

27. Id.
28. Id.
29. The January bylaw would have required any Datapoint shareholder wishing to solicit consents to elect directors to:
   (1) Give written notice of nominations to the board to the corporation 60 days in advance of execution of consents or mailing of solicitation material to stockholders;
   (2) disclose in the notice extensive details concerning the solicitation and nominees;
   (3) accept a record date not sooner than 30 days from the notice date.
   The bylaw also deferred the effective date of shareholder consent action until the 50th day after the record date, or during the pendency of any lawsuit brought by Datapoint (or anyone) challenging the validity of the consents and until the corporate secretary should determine the lawsuit not to be “pursued expeditiously and in good faith.”
30. Id. at 1033 n.3.
31. Id.; see DELL CODE ANN. tit. 8, § 228 (repl. vol. 1991).
32. Id. at 1036.
33. Id.; see id. at 1036.
34. Id.; see DELL CODE ANN. tit. 8, § 228 (repl. vol. 1991).
35. Id. at 951 n.2.
36. Id. at 951.
transportation services to be provided by another Edelman-controlled company. The overall picture, in short, is that of the alleged redirection of Datapoint assets to Edelman and his cohort directors, either directly or through intermediary partnerships and corporations. To be sure, the plaintiff's allegations in Heineman have not yet been tested at trial, and it may develop that the impugned transactions have merits that belie their appearances. At worst, the pattern of transactions illustrates the risk that the corporation may become a piggybank, holding all of its assets for the private use and benefit of its fifteen percent controlling shareholder and his allies on the board.

The allegations in Heineman are, perhaps, descriptive of unusually simple abuses, but they are not unique illustrations of inter-shareholder conflict arising after a shift in voting control. Beyond the basic piggybank scenario, two other situations are noteworthy. First, if a shareholder acquires voting control, it may translate an opportunity to sell corporate assets, through a transaction that benefits all shareholders proportionately, into an opportunity to sell control stock, a transaction that benefits the controlling shareholder exclusively. Second, a controlling shareholder who is optimistic about the future prospects of the corporation's business may be tempted to cash out the minority equity interest at an unduly low price.

The manner in which the controlling shareholder acquired control often is the source of potential conflict. Some types of problematic conduct may be more likely to follow the acquisition of voting control when, as in Heineman, voting control seems to have been acquired cheaply. A popular eighties-style strategy devised to prevent hostile takeovers was to recapitalize the corporation with classes of stock holding differential voting rights, on such terms that public shareholders would find it unattractive to remain or become owners of the class with greater voting power. Such a recapitalization enables a person or group of persons who make no additional equity investment in the corporation to acquire voting control.

In Thorpe v. CERBCO, Inc., a dual-class recapitalization enabled holders of less than forty-three percent of CERBCO's shares, over a
nine-year period, to acquire almost eighty percent of the class of stock with the power to elect seventy-five percent of CERBCO’s directors, while fellow shareholders converted into the low-voting-power class.\(^{39}\) CERBCO, a holding company, had as its principal asset a controlling stock interest in Insituform East, a sublicensee of Insituform of North America, Inc. (INA).\(^{40}\) The plaintiffs brought a derivative suit alleging that CERBCO’s controlling shareholders usurped a corporate opportunity when they agreed to sell their high-voting-power stock to INA, thereby depriving CERBCO and its other shareholders of the opportunity to sell CERBCO’s controlling stock in Insituform East directly to INA.\(^{41}\)

Controlling shareholders may determine that buying out the minority’s interest represents an attractive investment opportunity and additionally eliminates the risk of claims of breach of fiduciary duty in subsequent dealings between the controlling shareholder and the corporation. If the controlling shareholder compels the minority to sell by organizing a merger transaction, the terms of which cash out the minority, the controlling stockholder must be able to establish at a minimum that it dealt fairly and openly and priced the minority interest fairly.\(^{42}\) Some jurisdictions also require that a business purpose, separate from the controlling shareholder’s investment interest, support the cashout.\(^{43}\) In any event, several eighties-style leveraged acquisitions have evolved in the opposite direction, with the corporation selling equity interests to minority public investors for cash or other consideration including the exchange of debt securities.\(^{44}\)

\(^{39}\) *Id.* at 7. The court’s opinion does not explain the incentives provided to induce shareholders to convert their high-voting-power shares into the low-voting-power class. Many recapitalization plans induced conversion into low-voting-power stock—or discouraged conversion into high-voting-power stock, in the case of plans so structured—by promising a one-time dividend of a substantial amount, payable only to holders of shares in the low-voting-power class. *See, e.g.*, Lacos Land Co. v. Arden Group, Inc., 517 A.2d 271, 272-74 (Del. Ch. 1986) (describing a plan that offered a $0.30 dividend per share for holders of class A stock who did not exchange their share for class B stock that had greater voting powers).

\(^{40}\) 611 A.2d at 7.

\(^{41}\) *Id.* at 8.

\(^{42}\) *See, e.g.*, Weinberger v. UOP, Inc., 457 A.2d 701, 711 (Del. 1983) (stating that the fairness owed minority shareholders by majority shareholders is comprised of two components: “fair dealing and fair price”).

\(^{43}\) *See, e.g.*, Coggins v. New England Patriots Football Club, Inc., 492 N.E.2d 1112, 1118 (Mass. 1986) (“Because the danger of abuse of fiduciary duty is especially great in a freeze-out merger, the court must be satisfied that the freeze-out was for the advancement of a legitimate corporate purpose.”); Alpert v. 28 Williams St. Corp., 473 N.E.2d 19, 28 (N.Y. 1984) (“In the context of a freeze-out merger, variant treatment of the minority shareholders—i.e., causing their removal—will be justified when related to the advancement of a general corporate interest.”).

\(^{44}\) *See, e.g.*, Anders, supra note 3, at 86 (describing five successive refinancings by Kohlberg Kravis Roberts & Company (KKR) of RJR Nabisco, each retiring debt and issuing preferred or common shares); George Anders & Greg Steinmetz, KKR Planning to Take Public American Re, WALL ST. J., Nov. 25, 1992, at A3 (describing KKR plan to sell 24% of equity in reinsurance company, acquired through an LBO two months before announcement). Additionally, in its recent acquisition of the assets of the Bank of New England, KKR joined with a bank holding company and committed itself to remaining a
Advocates of LBO transactions often emphasize the gains in efficiency likely to be realized by eliminating "conflicts of interest between those who bear risk (the shareholders) and those who manage risk (the executives)." In particular, LBO advocates claim that organizational reforms that follow the elimination of widely diffused equity ownership cure waste and inefficiency in public corporations. Many LBOs conformed to these advocates' optimistic predictions. Heineman and Thorpe, however, illustrate that other types of transactions affecting control also occurred in the 1980s—ones that may have eliminated owner-manager conflicts by, in some rough sense, substituting conflicts among owners.

Eliminating minority equity interests held by public investors does not eliminate the risk of interowner conflicts. Case reports are replete with accounts of conflict among owners of closely held firms. Additionally, many eighties-style transactions led to equity ownership structures that seem vulnerable to interowner conflict. The history of Weirton Steel, spun off by National Steel in 1984 through an Employee Stock Ownership Plan (ESOP), further illustrates that the absence of public shareholders does not ensure harmony. Employees (including management-level employees) controlled seventy-two percent of the voting power in Weirton through the ESOP. After senior management announced a plan to cut the work force by twenty-five percent over a three-to-five year period, rank-and-file employee/shareholders and their union announced a challenge to senior management, including a possible proxy fight.

Likewise, LBOs themselves and the organizations that sponsor them do not seem immune to conflict among owners, despite the


More generally, a recent study of 183 large LBOs completed between 1979 and 1986 concluded that "the typical buyout is neither short-lived nor permanent." Steven N. Kaplan, The Staying Power of Leveraged Buyouts, 29 J. Fin. Econ. 287, 290 (1991). In this sample, as of August 1990, 62% of the LBO companies were privately owned, 14% were publicly owned and independent, and 24% had been purchased by a publicly owned foreign or domestic corporation. Id. at 289. Privately owned LBOs maintained higher ratios of debt to equity than did publicly owned ones. Id. at 305-06. Independent publicly owned LBOs, however, continued to have relatively concentrated equity ownership. After an initial public offering of equity, insiders held a median of 39% of the post-offering equity in such LBOs. Id. at 306-07.

45. See Jensen, supra note 19, at 64.
46. Id.
47. See generally O'Neal & Thompson, supra note 14.
50. Id.
absence of public shareholders. LBO organizers conventionally retain a majority of the equity in the new corporation created by the LBO while allocating some of the new corporation's equity to senior managers; in some transactions, lenders receive equity-based interests, such as warrants to buy common stock. If the new corporation's performance under the senior managers is financially insufficient, the interests of the LBO's sponsors are likely to diverge from those of the manager-shareholders, and perhaps also from those of lender-shareholders. The relationship, in short, is not inherently a harmonious partnership. LBO sponsors themselves experience episodes of conflict among their owners, including one widely reported suit alleging breach of contract and fiduciary duty in a firm's treatment of a founding partner and its limited partner investors.

B. Derivative Actions Against Controlling Shareholders: The ALI Framework

Courts in the United States have long treated controlling shareholders as fiduciaries. Although the boundaries and precise content of the fiduciary constraint are open to dispute, its application to controlling shareholders limits those controlling shareholders' ability to extract benefit from the corporation on a basis not proportionally available to all shareholders. As Heineman and Thorpe illustrate, many claims of overreaching by controlling shareholders allege injury primarily or initially visited upon the corporation, not upon its minority shareholders individually. Such claims, if the corporation does not pursue them itself, conventionally are asserted on its behalf by representative shareholders suing derivatively. The ALI's Principles address the content of controlling shareholders' duties as well as aspects of derivative litigation. The Article returns to the specifics of Heineman and Thorpe after examining the confluence of these two components of the ALI's Principles.

1. Duties of Controlling Shareholders

Like the drafters of the Revised Model Business Corporation Act, the

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51. Some writers may have supposed otherwise. See Jay O. Light, The Privatisation of Equity, Harv. Bus. Rev., Sept.-Oct. 1989, at 62, 63 (stating that after an LBO, the financial sponsor "becomes the managing owner in partnership with company managers").


53. See, e.g., Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971) (stating that parent corporation with controlling interest in subsidiary owes subsidiary a fiduciary duty).

54. The ALI Principles explain the basic point as follows: When "a director, officer, or controlling shareholder acts with a pecuniary interest in a matter," that person has an obligation "to act fairly toward the corporation and its shareholders." American Law Inst., Principles of Corporate Governance: Analysis and Recommendations Part V introductory note a, at 263 (Proposed Final Draft, 1992) [hereinafter Proposed Final Draft].
reporters for the *Principles* Project did not use "fiduciary" labels, applicable either to duties imposed or to persons subject to those duties.\textsuperscript{55} The *Principles* provide that controlling shareholders are subject to a duty of fair dealing when they are personally interested in a matter affecting the corporation—a duty comparable if not identical to that applicable to directors and senior executives.\textsuperscript{56} The *Principles* define a controlling shareholder as one who either alone or pursuant to an arrangement or understanding with another person or persons, either owns and has power to vote more than fifty percent of a corporation's outstanding voting equity securities or who by virtue of his position as a shareholder "otherwise exercises a controlling influence over the management or policies of the corporation or the transaction in question."\textsuperscript{57} The exercise of such a controlling influence is to be presumed, subject to rebuttal, when a person, whether alone or by arrangement with others, owns or has power to vote more than twenty-five percent of a corporation's outstanding voting equity securities, unless another person under the same circumstances has power to vote a greater percentage.\textsuperscript{58} Below the twenty-five percent threshold, no presumption of control applies.

As elaborated in the *Principles*, a controlling shareholder's duty of fair dealing consists of three separate applications and one significant corollary. First, a controlling shareholder self-deals by entering into a transaction with the corporation.\textsuperscript{59} The shareholder fulfills its duty of fair dealing if the transaction is fair to the corporation when entered into; or if it is authorized in advance by disinterested shareholders following disclosure of the transaction and the conflict, and the transaction does not constitute waste of the corporation's assets at the time of shareholder action.\textsuperscript{60} If disinterested directors authorize the transaction in advance, or if disinterested shareholders authorize or ratify it, the party challenging the transaction has the burden of proof.\textsuperscript{61}

Second, and similarly, a controlling shareholder may not take advantage of a corporate opportunity unless such taking is fair to the

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\item Proposed Final Draft, supra note 54, § 5.10. It is interesting that the most systematic scholarly critique of the *Principles* omits from its purview corporations that have controlling shareholders. See Michael F. Dooley, Two Models of Corporate Governance, 47 Bus. Law. 461, 463 n.9 (1992) (limiting analysis to publicly held firms, defined inter alia as those in which "management and residual claimant status (shareholding) are separable and separated functions" and residual claims (shares) are held by a number of persons).
\item Id. § 1.10(b).
\item Id. § 1.10(a).
\item Id. § 5.10(a).
\item Id.
\item Id. § 5.10(b).
\end{enumerate}
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corporation or the taking is authorized in advance or ratified, following disclosure of the conflict, by disinterested shareholders and the taking is not equivalent to a waste of corporate assets. Unless the taking is approved in advance by disinterested directors or shareholders, the controlling shareholder has the burden of proving fairness to the corporation.

Third, a controlling shareholder is constrained in its ability to secure a pecuniary benefit by using corporate property, using its controlling position, or, when trading in the corporation's securities, using nonpublic corporate information. If the use of property, position, or information is otherwise lawful, the Principles also provide that the controlling shareholder must give value for the use, and that the use must meet the standards applicable to self-dealing transactions; alternatively, any benefit from the use resulting for the controlling shareholder must be made proportionately available to other shareholders similarly situated unless the benefit is derived solely from the use of controlling position and is not unfair to other shareholders.

The corollary to these applications of the duty of fair dealing is that a controlling shareholder may not knowingly advance the pecuniary interest of an associate in a manner that would breach the controlling shareholder's own duty if it acted for itself. "Associates" include close family members and persons with whom one "has a business, financial, or similar relationship that would reasonably be expected to affect the person's judgment with respect to the transaction in question in a manner adverse to the corporation." A person holding more than ten percent of a class of equity in a business organization presumptively makes that organization an associate of the holder, unless the value of the holding to its holder is such that it would not reasonably be expected to affect the holder's judgment in a manner adverse to the corporation.

The most significant aspect of these formulations is the relatively minimal consequence they ascribe to the involvement of disinterested directors. If disinterested directors have approved a transaction proposed by a controlling shareholder in advance of its consummation, this approval simply shifts the relevant burden to the party challenging the propriety of the transaction. In contrast, if the self-dealing transaction involves a director or a senior executive, then advance approval or ratification by disinterested directors, following appropriate disclosure, legitimates the director or senior executive's involvement, so long as the disinterested directors "could

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62. Id. § 5.12(a).
63. Id. § 5.12(c).
64. Id. § 5.11(a).
65. Id.
66. Id. § 5.13.
67. Id. § 1.03(a)(1).
68. Id. § 1.03(a)(2).
69. Id. § 1.03(b).
reasonably have concluded that the transaction was fair to the corporation at the time of such authorization. 70

2. Derivative Litigation

The Principles' regulation of derivative litigation gives much greater weight to the involvement of disinterested directors, even when the suit challenges the conduct of a controlling shareholder. Like the Cheshire Cat, one of Alice's most memorable acquaintances down the Rabbit-Hole, disinterested directors appear and disappear, always with intriguing style, in various episodes of the Principles. 71

Prior to bringing a derivative action, under the Principles the prospective plaintiff must make a demand on the corporation's directors, requesting that they prosecute the action or take suitable corrective measures. 72 Under the Principles—in contrast to present law in most jurisdictions—making a demand is not excused even if it would be futile; the Principles excuse presuit demand only when the plaintiff makes a specific showing that irreparable injury to the corporation would otherwise result. 73 If the directors reject the demand, much turns under the Principles on whether a majority of the entire board was disinterested and whether the members of that majority "were capable as a group of objective judgment in the circumstances." 74 If the board does not meet these criteria, and, apparently, if the complaint so alleges with sufficient factual particularity, the court may not dismiss the suit on the basis that the directors rejected the demand. 75 If the directors satisfy the criteria, the

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70. Id. § 5.02(a).
71. In the context of determinations about derivative litigation, the Principles define a director to be interested if the director is a party to the impugned transaction or is controlled by such a party; if the director is named as a defendant, that circumstance does not make the director interested if the director only approved of, acquiesced in, or failed to object to the transaction, and if the facts alleged in the complaint do not otherwise raise a clear likelihood that the director would be adjudged liable to the corporation or its shareholders. Id. § 1.23(c). At the 1992 annual meeting, the Principles' Reporters agreed to consider whether § 1.23(c) should utilize the "significant prospect" standard instead of the "clear likelihood" standard in the Proposed Final Draft. See 69 A.L.I. Proc. 141, 175 (1992).
72. Proposed Final Draft, supra note 54, § 7.03(a).
73. Id. § 7.03(b).
74. AMERICAN LAW INST., PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS, MOTION TO AMEND § 7.04(A) OF THE PROPOSED FINAL DRAFT (1992) [hereinafter MOTION TO AMEND § 7.04(A)]. Section 7.04(a) was significantly amended after publication of the Proposed Final Draft of the Principles; the A.L.I.'s membership voted to adopt the amended version. See 69 A.L.I. Proc. 67, 131-32 (1992).
75. MOTION TO AMEND § 7.04(a), supra note 74. Prior to the amendment of § 7.04(a), the Principles did not treat directors' rejection of a demand as, in itself, mandating dismissal of a derivative suit. Proposed Final Draft, supra note 54, § 7.04(a). All dismissals were subject to the standards in §§ 7.08-10. If the complaint challenged a self-dealing transaction, under § 7.10, dismissal required that the court affirmatively find that the board or committee recommending dismissal was adequately informed and had
Principles require the court to dismiss the complaint prior to discovery unless the complaint pleads with particularity facts that create a significant prospect that the directors' rejection would not meet the requirements for the business judgment rule or, if the underlying transaction would not be reviewed under a business judgment standard, that "disinterested directors could not reasonably have determined that rejection of such demand was in the best interests of the corporation."  

3. The Inconsistent Significance of the Disinterested Director in the ALI Principles

The complexity of this formulation aside, its import for the focus of this Article is that if directors reject a demand concerning an alleged breach of the duty of fair dealing by a controlling shareholder, that rejection leads to dismissal of a derivative suit asserting the claim if a majority of the directors are disinterested and are capable as a group of objective judgment, unless the directors' decision to reject substantively fails the test of "could not reasonably have determined" or unless the decision fails to meet the criteria for the business judgment rule.  

Under the Principles, the business judgment rule protects directors' decisions if the directors are disinterested in the subject of the judgment, are informed to the extent the directors reasonably believed appropriate under the circumstances, and rationally believed the judgment to be in the corporation's best interests. The first two criteria apply to the process the directors followed in making their determination to reject the demand; the requirement of rational belief seems to have more substantive content.

One might wonder why disinterested directors—so marginal under the Principles in legitimating transactions between the corporation and its controlling shareholder—become so dispositive in the litigious aftermath of such a transaction. If the transaction itself is approved in advance by disinterested directors, acting in the manner sanctioned by the business judgment rule, the directors' approval only shifts the burden of proof to the party challenging the transaction. In contrast, if disinterested directors acting in like manner reject a demand impugning the same transaction, their rejection mandates dismissal of an ensuing derivative suit, subject only to the

reasonably determined that dismissal was in the corporation's best interests, on grounds that the court deemed to warrant reliance.

76. Motion to Amend § 7.04(a), supra note 74.
77. See supra notes 74-76 and accompanying text.
78. Proposed Final Draft, supra note 54, § 4.01(c).
79. Whether a director's belief is rational goes beyond whether the director, in fact, held the belief; the determination required is to some extent objective. Professor Melvin A. Eisenberg, Chief Reporter for the Principles, characterizes a rationality standard as one of explicability. The relevant question is whether the director explained, or could explain, his decision; it is irrelevant that most directors, acting reasonably, would not have made the same decision. See Melvin A. Eisenberg, The Duty of Care of Corporate Directors and Officers, 51 U. PITT. L. REV. 945, 960-62 (1990).
80. See supra notes 59-70 and accompanying text.
substantive exception for decisions made by directors who "could not reasonably have determined that rejection of such demand was in the best interests of the corporation."\textsuperscript{81}

If disinterested directors are marginalized on the transactional front due to fear that a controlling shareholder's power to elect and remove directors may import a capacity to control—a capacity the exercise of which may elude judicial scrutiny—the same concern seems applicable to the derivative litigation front as well. In short, like the Cheshire Cat, disinterested directors seem inscrutable in their propensity to disappear and then rematerialize in the Principles. But then, we may recall that when Alice, in search of directions, asked the Cat, "Would you tell me, please, which way I ought to go from here?" the Cat responded, "That depends a good deal on where you want to get to."\textsuperscript{82} Unfortunately, it is not evident what direction the Principles pursue.

C. Current Law Contrasted

The Principles and Delaware law deal somewhat differently with claims asserted derivatively against controlling shareholders. These differences, although not enormous, are intriguing. Like most jurisdictions, but unlike the Principles, Delaware excuses the plaintiff's failure to make a demand prior to filing a derivative suit when making a demand on directors would be futile.\textsuperscript{83} If demand is excused, Delaware permits the board to create a litigation committee composed of disinterested members to evaluate the claim and the corporation's interests.\textsuperscript{84} If, based on the committee's recommendation, the corporation moves to dismiss the derivative suit, the corporation has the burden of establishing the absence of any triable issue of fact as to the committee's good faith, independence, and bases supporting its conclusions.\textsuperscript{85} Moreover, the court has discretion to evaluate the merits of the suit and, on that basis, to deny the motion to dismiss.\textsuperscript{86} In contrast, if the plaintiff makes a demand, most Delaware cases hold that the plaintiff thereby has conceded the board's independence.\textsuperscript{87} These lines of demarcation in practice are less rigid in Delaware than they initially appear to be when the claim alleges

\textsuperscript{81} Motion to Amend § 5.04(a), supra note 74, § 7.04(a).
\textsuperscript{82} Carroll, supra note 1, at 78.
\textsuperscript{84} See, e.g., Zapata Corp. v. Maldonado, 430 A.2d 779, 786-89 (Del. 1981) (permitting board of directors whose majority was self-interested to delegate power over litigation decisions to an independent committee of two disinterested board members).
\textsuperscript{85} See id. at 788.
\textsuperscript{86} See id. at 787-88; see also Kaplan v. Wyatt, 499 A.2d 1184, 1188-92 (Del. 1985) (holding that court may exercise its own independent business judgment and evaluate the motion to dismiss).
\textsuperscript{87} See, e.g., Levine v. Smith, 591 A.2d 194 (Del. 1991) ("A shareholder plaintiff, by making demand upon a board before filing suit, 'tacitly concedes the independence of a
wrongdoing by a controlling shareholder.\footnote{88} Recent Delaware opinions resolving demand issues demonstrate that the Delaware courts are noticeably sensitive to the risk of problematic behavior by controlling shareholders. In particular, Delaware courts are reluctant to foreclose judicial examination of the merits of self-dealing transactions on the basis of demand-related obstacles if the circumstances appear dubious. Earlier Delaware cases excused demand when the plaintiff’s factually particular allegations raised a reasonable doubt that directors are not disinterested and independent, and that the challenged transaction was otherwise not the product of business judgment.\footnote{89} In \textit{Heineman},\footnote{90} the Delaware Supreme Court held that demand was excused as to the plaintiff’s first two claims—using corporate assets to reimburse expenses incurred in the battle to control Datapoint and investing in an arbitrage pool—because a majority of Datapoint’s directors themselves had personal financial interests in the impugned transactions.\footnote{91} The plaintiff thereby satisfied the criterion of alleging with particularity facts that raise a reasonable doubt as to the disinterest or independence of a majority of the directors.

In contrast, the remaining two claims challenged transactions between Datapoint and Edelman-controlled business entities in which a majority of Datapoint directors were not themselves financially interested.\footnote{92} Delaware case law does not excuse demand simply on the basis of conclusory allegations that directors are controlled or dominated; the plaintiff must meet a standard of factual particularity, alleging that “the board members who approved the transaction are acting at the direction of the allegedly dominating individual or entity” so as to establish a “nexus between the domination and the resulting personal benefit to the controlling party.”\footnote{93} Although the complaint in \textit{Heineman} failed to meet this standard, the court declined to dismiss the two claims on that basis. Instead, the court permitted the plaintiff to file a second amended complaint to expand further the allegations that Datapoint’s directors were dominated and controlled.\footnote{94} Interestingly, the court noted that the plaintiff would be able to take discovery on the two claims for which demand was excused, an opportunity that might produce additional facts pertinent to the demand issues surrounding the two remaining claims.\footnote{95}

\footnote{88} As explained infra notes 100-03 and accompanying text, the court in \textit{Thorpe} declined to impose an insurmountable barrier to judicial review on the basis that the plaintiff had made a demand.

\footnote{89} \textit{See} Aronson v. Lewis, 473 A.2d 805, 814 (Del. 1984).

\footnote{90} \textit{Heineman v. Datapoint Corp.}, 611 A.2d 950 (Del. 1992), discussed supra notes 25-34 and accompanying text.

\footnote{91} \textit{See id.} at 952-54.

\footnote{92} \textit{See id.} at 954-56.

\footnote{93} \textit{Id.} at 955.

\footnote{94} \textit{Id.} at 955-56.

\footnote{95} \textit{Id.} at 956.
In general, under Delaware law, once the plaintiff makes a demand on directors, the plaintiff is deemed to have conceded the board’s independence for purposes of responding to the demand.\textsuperscript{96} If the board refuses the demand, courts will review the refusal under the business judgment rule.\textsuperscript{97} Once the plaintiff concedes independence, the court’s attention is focused on the good faith and reasonableness of the directors’ investigation.\textsuperscript{98} \textit{Thorpe v. CERBCO, Inc.},\textsuperscript{99} however, suggests additional bases on which a refusal may be challenged.

In \textit{Thorpe}, the plaintiffs demanded that the board prevent the controlling shareholders’ sale of stock.\textsuperscript{100} The board established a two-member committee to review the demand; after the committee reported to the entire board, the committee members resigned as directors and, the plaintiffs alleged, the board did not act on their report.\textsuperscript{101} Although it expressly assumed that the two-member committee acted reasonably and in good faith, the Court of Chancery held that the committee’s effort itself could not preclude judicial review of the underlying claim against the controlling stockholder.\textsuperscript{102} The committee itself seems not to have been the corporation’s decisionmaker on the demand. In addition, the plaintiff’s allegations created a reasonable doubt about the good faith of the entire board, which failed to act on the committee report and failed, after request, to disclose it to shareholders.\textsuperscript{103}

Reexamining Heineman and Thorpe in the light of the Principles is instructive in two respects. First, the resolution of the most common scenarios, exemplified by Heineman, does not differ much from current Delaware law. Second, the resolution of uncommon but troublesome scenarios, exemplified by Thorpe, is under the Principles arguably less sensitive to the factual specifics of the situation and, in any event, cumbersome. Under the Principles, dismissal would not be available for claims like the first two in Heineman, which challenged transactions in which a majority of the directors had personal financial interests. If a majority of the directors lack such interests, and the plaintiff’s mandatory demand is rejected, the Principles presumptively, like current Delaware law, require dismissal prior to discovery. The plaintiff may defeat the motion to dismiss if a majority of the directors, are, under the Principles, “interested” in the transaction because they are “subject to a controlling influence by a party

\textsuperscript{96} See supra note 87 and accompanying text.

\textsuperscript{97} E.g., Levine v. Smith, 591 A.2d 194, 205, 207-08 (Del. 1991).

\textsuperscript{98} Id. at 212 (citing Spiegel v. Buntrock, 571 A.2d 767, 777 (Del. 1990)).

\textsuperscript{99} 611 A.2d 5 (Del. Ch. 1991).

\textsuperscript{100} Id. at 8.

\textsuperscript{101} Id.

\textsuperscript{102} Id. at 11.

\textsuperscript{103} Id. at 8.
to the transaction or a person who has a material pecuniary interest in the transaction, and that controlling influence could reasonably be expected to affect the director's . . . judgment with respect to the transaction in a manner adverse to the corporation."104 Because the Principles, like current Delaware law, seem to require the plaintiff to plead her facts with particularity on demand-related questions,105 allegations comparable to those required by Heineman would be necessary under the Principles' standard of "subject to a controlling influence."

In addition, under the Principles, the defendant is not entitled to dismissal of the suit unless, at the time of rejecting the demand, the directors "were capable as a group of objective judgment in the circumstances."106 Although the ALI formulation differs from Delaware law, this criterion seems likely, as applied, to be comparable to the Delaware requisites for applying the business judgment rule to the directors' decision.107 Finally, the opinion in Heineman is sanguine about the prospect that, prior to repleading in a further attempt to establish that demand should be excused, the plaintiff will likely have had the benefit of discovery on demand-excused claims.108 This possibility, evident as well in earlier Delaware cases,109 is not acknowledged in the Principles.

In contrast, the circumstances in Thorpe are more difficult to analyze under the Principles. The Principles may be read mechanically to produce the same outcome achieved by the Court of Chancery in Thorpe, because the relevant section in the Principles mandates dismissal when a demand is rejected by directors who were not interested in the transaction, and "such directors constituted a majority of the entire board."110 If the board's inaction in Thorpe111 is equated to rejection, then this basic criterion for dismissal would not have been satisfied. The Principles themselves, however, do not

104. Proposed Final Draft, supra note 54, § 1.23(a)(4).
105. See MOTION TO AMEND § 7.04(a), supra note 74 (requiring plaintiff to plead facts "with particularity").
106. Id.
108. Id. at 956.
109. Black-letter Delaware law denies the plaintiff any right to discovery in the demand context. See, e.g., Levine v. Smith, 591 A.2d 194, 208-10 (Del. 1991) (demand-refused context); Aronson v. Lewis, 473 A.2d 805, 816 (Del. 1984) (demand-excused context). Nonetheless, several Delaware cases examining demand-related questions, such as Heineman, acknowledge that, for various reasons, the plaintiff has been or will be able to take discovery. See Heineman, 611 A.2d at 956. If the plaintiff initially alleges individual claims along with the corporate claims, discovery is possible on the individual claims. Cf. Harris v. Carter, 582 A.2d 222, 224 (Del. Ch. 1990) (allowing discovery where derivative suit originally brought as class action; following discovery, plaintiff filed amended complaint asserting claims derivatively); Edelman v. Phillips Petroleum Co., No. 7899, 1985 WL 11534, at *11 (Del. Ch. Feb. 12, 1985) (denying injunction requested by shareholder-plaintiff challenging proposed recapitalization in class action and derivative suit after expedited discovery).
110. MOTION TO AMEND § 7.04(a), supra note 74.
draw this equivalence and do not separately consider director inaction as a basis for dismissal.\textsuperscript{112} Moreover, as noted above, the Principles disallow dismissal when the directors were not "capable of objective judgment in the circumstances,"\textsuperscript{115} a standard that, unlike the opinion in Thorpe, focuses on the board's capability rather than its actual conduct. Substantively, for transactions like that in Thorpe, the Principles deny dismissal when "disinterested directors could not reasonably have determined that rejection of such demand was in the best interests of the corporation"\textsuperscript{114}—again, a standard that, unlike Thorpe, steers the court away from careful and nuanced examination of actual conduct.

More generally, the Principles—like the recent amendments to the Revised Model Business Corporation Act\textsuperscript{115}—mandate universal demand. That is, the Principles require the plaintiff to make a demand even when the exercise is likely to prove futile. It is not evident from the extensive commentary accompanying the Principles whether their drafters specifically considered the usefulness of mandating demand when the corporation has a controlling shareholder and the claim impugns a transaction in which that shareholder has an interest. Earlier drafts of the Principles, in justifying limits on the import of litigation committee recommendations, stressed the possibility that even financially disinterested directors "may be subject to a bias or conflict of interest that would not be overtly discernible to the court,"\textsuperscript{116} an especially likely possibility when the corporation has a controlling shareholder. Moreover, to identify facts probative of nonovertly discernible bias or conflict is difficult without discovery. Interestingly, although commentary to the Principles criticizes as "ambiguous"\textsuperscript{117} the Delaware standard of "reasonable doubt" applicable to demand-related pleadings, Delaware cases justify the standard as permitting a judicial tradeoff between the risk that a derivative suit has been abusively filed versus the burden on the plaintiff of being compelled to plead evidence without benefit of

\textsuperscript{112} Section 7.03, which contains the basic requirement of universal demand, is accompanied by commentary explicitly acknowledging that the plaintiff may file the action if the board does not make a timely response to the demand. See Proposed Final Draft, supra note 54, § 7.03 cmt. f, at 658. Section 7.04, however, which dictates the demand-generated bases for dismissal, does not itself deal with a board's failure to respond. See Motion to Amend § 7.04(a), supra note 74. In contrast, the Revised Model Business Corporation Act readily reaches the same outcome as Thorpe, because it conditions dismissal on whether the "conclusion" reached by the relevant group is based on a reasonable inquiry conducted in good faith. Model Business Corp. Act § 7.44(a) (rev. ed. 1991).

\textsuperscript{113} See Motion to Amend § 7.04(a), supra note 74.

\textsuperscript{114} Id.


\textsuperscript{117} See Proposed Final Draft, supra note 54, § 7.03 reporter's note 5, at 665.
discovery.118

The Principles criticize current Delaware law as complex and, implicitly, somewhat formalistic in its treatment of demand-related issues.119 As Thorpe illustrates, however, Delaware jurisprudence is capable of being applied in a highly context-sensitive manner that seems antithetical to formalistic judging. Overt antiformalists, of course, achieve nothing of substance by advocating the substitution of one mechanical formulation for another. Indeed, in the relationships explored in this Article, mechanical rules are especially ill-suited to regulate litigation challenging problematic transactions between a corporation and its controlling shareholder.

It seems unlikely as well that the formulation in the Principles will significantly reduce the volume or significance of demand-related threshold litigation.120 This rationale for universal demand is undermined by the dispositive consequences the Principles now attach to demand-related circumstances.121 Under the Principles, once the corporation’s directors reject a demand, the court must dismiss the derivative suit unless the plaintiff alleges with particularity facts that raise a significant prospect that, in essence, the rejection should not lead to dismissal. In particular, if the suit challenges a transaction with a controlling shareholder, dismissal may be averted by alleging that the directors who rejected the demand were not disinterested, that as a group they were not capable of objective judgment in the circumstances or did not qualify for the protections of the business judgment rule in making the decision to reject the demand, or that the directors could not reasonably have believed rejection to be in the corporation’s best interests. Attaching dispositive consequences to rejection, in short, invites threshold litigation over the legitimacy of the rejection. Delaware law at present invites threshold litigation by ascribing consequences to the plaintiff’s decision to make a demand and to the court’s evaluation of whether demand should be required. It is not evident that less threshold litigation would ensue under the Principles.

III. Controlling Shareholder Conflicts with Creditors

Eighties-style transactions in control frequently resulted, posttransaction, in heavily indebted business entities. Defenders of such transactions, in particular defenders of LBOs, acknowledge the risk that equity holders (and management) in such entities had incentives to take high-risk business gambles: “If their gambles succeed, they reap large rewards by increasing their equity value; if their gambles fail, creditors bear much of the cost.”122 A significant inhibition on such conduct is that LBO sponsors are, or hope to be,

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119. See Proposed Final Draft, supra note 54, § 7.03 cmt. d, at 654 (“[T]he Delaware rule on demand futility has a special complexity.”).
120. See id. § 7.03 cmt. e, at 656-57.
122. See Jensen, supra note 19, at 70.
repeat players in eliciting lender involvement in transactions, an objective that imposes serious reputational consequences on opportunist or unduly risky behavior by holders of equity interests in the debtor.\textsuperscript{123}

Inevitably, however, once down the Rabbit-Hole, implausible and unlikely scenarios come true. In particular, a highly leveraged debtor in a parlous immediate predicament may be less inhibited by the reputational consequences of creditor-disfavored behavior than are highly leveraged debtors as a class. In the wake of such behavior, difficult legal questions may arise: Is the debtor free to engage in all behavior that is not expressly prohibited by the loan agreement? To what extent should the contract-law duty of good faith be a source of additional inhibitions on the debtor’s conduct, in addition to inhibitions imposed explicitly by the loan agreement?\textsuperscript{124} Should legal norms vary depending on the type of creditor?\textsuperscript{125} That is, should the court interpret the duty of good faith more expansively when the objecting creditor is a bondholder or a holder of a publicly offered debt security, than when a sole lender objects to debtor conduct that violates no express provision in a negotiated loan agreement?\textsuperscript{126}

Curiously, although the ALI’s Principles deal at length with transactions in control and defenses to takeover bids, they do not directly address these questions, the emergence of which seems inevitable following the highly leveraged transactions that were consummated in the 1980s. The sequence of events in Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp.\textsuperscript{127} illustrates debtor opportunism in the wake of an LBO gone awry. In Credit Lyonnais, a corporation controlled by Giancarlo Parretti and his wife, Maria Cecconi, acquired MGM/UA Communications Company in a highly

\textsuperscript{123} See id.

\textsuperscript{124} Similar questions are generated by the impact of the debt necessary to finance an LBO on holders of debt securities previously issued by the corporation—debt securities that inevitably suffer from a decline in credit ratings. See Metropolitan Life Ins. Co. v. RJR Nabisco, Inc., 716 F. Supp. 1504, 1519-23 (S.D.N.Y. 1989) (holding that in undertaking debt to finance LBO, and thereby causing decline in market price of previously issued debt securities, corporation did not breach implied covenant of good faith and fair dealing).

\textsuperscript{125} In Metropolitan Life, the court emphasized the sophistication of the institutional holders of the RJR debt issued before the LBO. Id. at 1522. Not all institutional holders, however, are equal in investment savvy or closeness to the market.

\textsuperscript{126} See Victor Brudney, Corporate Bondholders and Debtor Opportunism: In Bad Times and Good, 105 Harv. L. Rev. 1821, 1870-71 (1992) (arguing that sole lender might undertake informed adversarial bargaining over express limits imposed on debtor conduct by loan agreement; dispersed bondholders have no opportunity even remotely comparable and are not likely to understand scope of debtor’s unilateral discretion). As in most settings, line drawing can be a challenge. Should financial institutions that participate in a syndicate loan be analogized to dispersed holders of debt securities? Or to a sole lender?

leveraged late-eighties LBO. 128 Within five months of the LBO, MGM's trade creditors filed a bankruptcy petition to liquidate MGM; even sooner after the transaction, concluded the court, "in an accounting sense, [MGM was] out of control within weeks" 129 after the transaction. Indeed, in the immediate aftermath of the LBO, at Parretti's direction MGM adopted an internal "slow pay" policy for its trade creditors. 130 Credit Lyonnais, the principal LBO lender, insisted on a corporate governance agreement that effectively insulated MGM from Parretti's control in exchange for lending additional funds to the visibly distressed debtor. 131 Parretti nonetheless persisted in attempts to dominate MGM's operations and to undermine the authority of the executive committee that the agreement created. In particular, Parretti sought to cause MGM to liquidate certain assets over the objection of the executive committee and Credit Lyonnais. 132 Eventually the lender removed Parretti and his allies from office, using voting rights conferred by the corporate governance agreement. 133

The Court of Chancery's opinion in Credit Lyonnais is famous in some circles, 134 but not for its resolution of the specific dispute between Parretti and the lender. After its removal of Parretti and his allies from the MGM board, the lender brought an action for judicial determination of the identity of MGM's lawfully elected directors. 135 Parretti responded by unsuccessfully challenging his removal as a director. The court's opinion evaluates at length whether Parretti's conduct, after his assent to the corporate governance provisions, met the contractual standard of good faith in performance. 136 Concluding that Parretti had not acted in good faith, the court observed, "while contracting parties are not fiduciaries for each other, there are outer limits to the self-seeking actions they may take under a contract. Where one party's actions are such as to deprive the other of a material aspect of the bargain for which he contracted," he has failed to deal fairly and in good faith. 137 In particular, Parretti took actions that were actively disruptive to the executive committee's operational control, actions beyond the scope of those arguably permitted as a result of ambiguities and omissions in the corporate governance agreement. 138

The fame of Credit Lyonnais stems from the court's statement that,

\[128. \textit{Id. at *7-8.}\]
\[129. \textit{Id. at *8.}\]
\[130. \textit{Id. at *21.}\]
\[131. \textit{Id. at *32-33.}\]
\[132. \textit{Id. at *54.}\]
\[133. \textit{Id. at *70.}\]
\[135. \textit{Credit Lyonnais, 1991 Del. Ch. LEXIS 215, at *70; see DEL. CODE ANN. tit. 8, § 225 (repl. vol. 1991) (giving the Court of Chancery the authority to "determine the validity . . . of any director . . . and . . . determine the person entitled [to the office]").}\]
\[137. \textit{Id. at *76-77.}\]
\[138. \textit{Id. at *77-87.}\]
“where a corporation is operating in the vicinity of insolvency, a board of directors is not merely the agent of the residue risk bearers, but owes its duty to the corporate enterprise.” 139 Defined further in a footnote, “the corporate enterprise” as a legal and economic entity encompasses the interests of creditors and employees, along with shareholder interests; 140 directors of a corporation operating in the vicinity of insolvency “will recognize” in managing its business that in some circumstances “the right (both the efficient and the fair) course to follow” may diverge from the choice that creditors, employees, or shareholders would make unilaterally. 141 Perhaps by design, these passages in Credit Lyonnais raise many questions worthy of reflection, including: What sort of duty do directors owe to “the corporate enterprise,” including its creditors? If the directors’ duty passes through the enterprise to its creditors, should directors be treated as fiduciaries toward the creditors?

The difficulty with the concept of “corporate enterprise,” of course, is that “the enterprise” also includes the shareholders whose wishes, like those of Parretti, may well diverge from the creditors’ preferred course of action. For that matter, suppose MGM’s executive committee cooperated with Parretti in his plans to liquidate MGM’s assets, over the objection of Credit Lyonnais. Should the directors’ duty to “the enterprise” empower Credit Lyonnais to enjoin the asset disposition, if nothing in the loan agreement or the corporate governance agreement gives the lender a veto over transfers of assets? In addition, does the directors’ duty to the enterprise reach back in time, to the decision (probably made by other individuals then serving as directors) to undertake a highly leveraged transaction that placed the corporation in the suburbs of insolvency if not in its immediate vicinity?

These quandaries are most readily resolved—indeed, they are avoided—by viewing Credit Lyonnais simply as an express endorsement of the range of interests that directors may, consistent with the business judgment rule, take into account in good faith when a still-solvent corporation seems to be veering into insolvency. 142 Indeed, although directors owe some duties directly to shareholders, the conventional assumption is that directors’ duties are owed to the

139. Id. at *108.
140. This definition of the “corporate enterprise” encompasses a narrower range of interests than do many statutes that authorize or require directors to consider non-shareholder interests in responding to a hostile takeover bid. See Proposed Final Draft, supra note 54, § 6.02 cmt. a, at 553-54 (citing examples of such statutes). Delaware has not enacted such a “constituency” statute.
142. This interpretation, to be sure, reads down the import of the court’s statement that directors “will recognize” that the enterprise encompasses divergent interests, from mandate to exhortation or prediction.
corporation.\textsuperscript{145}

The more aggressive reading of \textit{Credit Lyonnais} characterizes directors as creditors' fiduciaries once the corporation is in the vicinity of insolvency. This characterization is difficult to reconcile with the court's starting proposition that "contracting parties are not fiduciaries for each other."\textsuperscript{144} The directors are not themselves parties to the corporation's contract with the creditor (unless they expressly become so); if the corporation itself is not a fiduciary toward its creditors, why would the directors be? Additionally, once the corporation enters the vicinity of insolvency, its creditors and controlling shareholders are more likely to disagree than they would be in more placid times. Unless the directors' fiduciary duty to the creditor means that they must disregard the controlling shareholder's wishes when they conflict with the creditors' preferences, the directors simply have discretion to make their own decision, discretion that they must exercise in good faith.

In any event, although the ALI finally adopted the \textit{Principles} in 1992, well into the aftermath of eighties-style transactions, the \textit{Principles} do not address the kinds of questions suggested by \textit{Credit Lyonnais}. More generally, on the question of the relative primacy of equity-holder interests, the \textit{Principles} state that a corporation "should have as its objective the conduct of business activities with a view to enhancing corporate profit and shareholder gain."\textsuperscript{145} Relatedly, to be protected by the business judgment rule, informed and financially disinterested directors must act in good faith and must "rationally believe[] that the business judgment is in the best interests of the corporation."\textsuperscript{146} In short, the \textit{Principles} leave to case-by-case construction and application the content of these general norms once a corporation's circumstances become, in Alice's terminology, "curiouser and curiouser."\textsuperscript{147} In contrast, as this Article itself illustrates, the \textit{Principles} embrace other topics with complex and detailed formulations. The \textit{Principles'} silence on the difficult questions suggested by \textit{Credit Lyonnais} thus limits their usefulness.

\textbf{Conclusion}

Long did the ALI labor over the \textit{Principles}. The ALI's review of its Corporate Governance Project extended from 1982 to 1992,\textsuperscript{148} encompassing a decade that featured numerous transactions affecting

\textsuperscript{143} Proposed Final Draft, \textit{supra} note 54, § 4.01(a) (stating that director's duty to perform functions in good faith, in a manner reasonably believed to be in corporation's best interests, and with the care an ordinarily prudent person would reasonably be expected to exercise in a like position and under similar circumstances, is a duty owed to the corporation).

\textsuperscript{144} \textit{Credit Lyonnais}, 1991 Del. Ch. LEXIS 215, at *76-77.

\textsuperscript{145} Proposed Final Draft, \textit{supra} note 54, § 2.01(a).

\textsuperscript{146} Id. § 4.01(c)(3).

\textsuperscript{147} See \textit{Carroll}, \textit{supra} note 1, at 19.

\textsuperscript{148} Michael Greenwald, \textit{Institute Gives Final Approval to Corporate Governance Project, ALI Rep.}, July 1992, at 1, 1.
corporate control, including highly leveraged megadeals and transactions that, at least initially, evoked bitter resistance from the corporation's incumbent directors and senior management. The controversy surrounding these transactions may help explain why the Principles pay scant attention to questions inevitably arising in their aftermath. Like the White Rabbit, the Principles seem to lag a bit behind events. Perhaps relatedly, the Principles do not take a consistent view of the judgmental capacity of financially disinterested directors in a corporation with a controlling shareholder. An intense interest in currently topical matters, such as contested changes in corporate control, may divert attention from less-immediate, but unavoidable, questions.