CORPORATE GOVERNANCE

The Representative Director Problem

Directors representing controlling shareholders, venture capitalists and preferred shareholders are elected to protect the interests of their sponsors. Nevertheless, accepted doctrine says that they owe undivided loyalty to the corporation and all shareholders. Business needs in both closely held and publicly traded corporations require a more realistic and nuanced legal approach to the position of a representative director.

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Corporate cases and literature seldom consider the special position of a director who is the nominee of a shareholder, group of shareholders, creditor, or other interested party. For these representative directors, the authorities avoid discussion in favor of a simple message of principle: a director must act on behalf of the corporation and all shareholders. In practice, however, directors usually are expected to serve as representatives of the sponsor. The result is an unnecessary separation of legal doctrine from corporate activity that can create confusion, expense and possible liability.

Background

The relevant basic standard of director conduct was stated in the 1994 edition of the *ABA Corporate Director's Guidebook* as follows: "A director should exercise independent judgment for the overall benefit of the corporation and all of its shareholders, even if elected at the request of a controlling shareholder, a union, a creditor, or an institutional shareholder or pursuant to contractual rights."[1] This categorical position is derived from the director's duty of loyalty articulated in cases such as *Guth v. Loft*:[2] A leading application of the duty of loyalty standard to the representative director is found in *Weinberger v. UOP, Inc.*,[3] a parent-subsidiary situation, where the Delaware Supreme Court referred to an "uncompromising duty of loyalty," and stated:

> Given the absence of any attempt to structure this transaction on an arm's length basis, Signal cannot escape the effects of the conflicts it faced, particularly when its designees on UOP's board did not totally abstain from participation in the matter. There is no "safe harbor" for such divided loyalties in Delaware. When directors of a Delaware corporation are on both sides of a transaction, they are required to demonstrate their utmost good faith and the most scrupulous inherent fairness of the bargain.
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> There is no dilution of this obligation where one holds dual or multiple directorships, as in a parent-subsidiary context. Thus, individuals who act in a dual capacity as directors of two corporations, one of whom is the parent and the other subsidiary, owe the same duty of good management to both corporations, and in the absence of an independent negotiating structure or the directors' total abstention from any participation in the matter, this duty is to be exercised in light of what is best for both companies.[4] (citations omitted)

The rigid position that the duty of a director is to the corporate entity for the benefit of all shareholders contrasts sharply with the well recognized right of shareholders to vote and trade their shares as they please in their own interests.[5] Although this shareholder freedom may be limited in extreme situations by the obligation not to abuse minority shareholders and not to sell control to looters or take other actions that would injure the corporation, shareholders are expected to act selfishly. The distinction in the conventional corporate model between director and shareholder duties breaks down most clearly in close corporations when the same person often is both a director and a major shareholder. In close corporations, the artificial and unworkable status distinction often is ignored and the parties are expected to pursue their own interests in both capacities with some outside fairness limits. It is prudent under present doctrine, however, to put veto rights and other controls at the shareholder level to avoid claims of breach of fiduciary duty by a representative director.

In both closely held and publicly traded corporations, common experience shows that the parties expect that a representative director will express the views of the party that the director represents. There is little purpose in cumulative voting and class election of directors if the directors chosen do not advocate the views of the shareholders electing them. Similarly, directors designated through contract rights by creditors or venture capitalists are expected to favor the interests of those designating them. The problem arises under the corporate norm when expected advocacy by a representative director evolves into actions of the director, whether in considering transactions with the sponsor, a veto of a corporate action, information sharing or other actions that may benefit the sponsor.

Parent-Subsidiary Transactions

The most restrictive discussions of representative director duties involve transactions between a corporation and its controlling shareholder. In the *Weinberger* case quoted above, the Delaware Supreme Court criticized the directors representing the parent for not disclosing to the other directors an analysis done for the parent of the value of the subsidiary on whose board they served, and attributed to the directors' actions to the parent. In discussing parent-subsidiary transactions, Delaware courts have not dealt clearly with the effect of Delaware section 144 concerning interested director transactions in the analysis of the fiduciary duties of the controlling shareholders.[6] The courts in the parent-subsidiary merger situation seem to assume that the directors affiliated with the controlling parent corporation were agents of the parent and focus on the duties of the controlling shareholder and the independence of the other directors.[7]

Despite the rigidity of the general proposition that a representative director must act independently, cases allow promotion of a sponsor's interest and transactions with the sponsor if reasonable procedures are followed. In one of the few discussions of the problem of the representative director, the author reviewed *Weinberger* and the cases of *Johnson v. Trueblood*[8] and *Sinclair Corp. v. Levien*[9] and concluded that

> The cases that deal with self-dealing transactions between a controlling stockholder and the controlled corporation cannot be reconciled with the existence of any general prohibition against action by a director who represents a particular stockholder to further that interest. What may be required, however, is first, a high degree of candor by the representative director, and second, in situations in which the potential for conflict is acute, the informed vote of the disinterested board members.
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> Even where disinterested director approval is not achievable, cases such as *Trueblood* and *Levien* suggest that, outside the realm of true self-dealing, there is a broad zone in which the assertion of a particular stockholder's interest will not defeat application of the business judgment rule.[10]

Labor Representatives

The representative director problem arises in various corporate situations, some of which involve labor unions. In an unusual recent case in a trial court in Washtenaw County, Michigan, the UAW invested in a broadcasting company and designated two directors. The plaintiff complained that the UAW representatives on the board breached their fiduciary duty to the corporation and the shareholders because "instead of the exercise of their duties in the maximization of profit, the UAW representatives on the board, . . . tailored their activities to accomplish the UAW's political objectives."[11] Although the director defendants were successful at the trial level on the facts, there was little guidance in the law for the parties as to whether representative directors could sacrifice the profitability of a corporation to satisfy the social or political views of the shareholders that designated the directors. In light of the general principles stated for director conduct, courts are forced to squeeze such actions within the general protections of the business judgment rule.

In another, more celebrated, situation involving the UAW, the nomination of the union's president, Douglas Fraser, to the board of Chrysler Corporation led to discussions of labor representation.[12] Concerning his service as a representative director, Mr. Fraser commented on his Chrysler experience in a lecture as follows:

> The next argument from the public was one that really bothered me. They said, "Well, if you assume a position on the Board, you have to behave exactly like any other Board member. Your exclusive responsibility is to

> the stockholders in the corporation." That was an unsatisfactory posture for me to be in, and they injected the issue of fiduciary responsibilities and all of the responsibilities I had as a Board member. So the end result was that I was exactly the same as anyone else and no different.
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> We handled this by meeting with the Chrysler Corporation and getting them to agree that they would have a statement on the proxy statement that went to all the shareholders.... The statement to the stockholders said basically this: that I viewed my position on the Board as different than other Board members, that I viewed myself going in there as a representative of the workers. I think I also said that I see nothing inconsistent with this.[13]

Class Representatives under English Law

While the maxim prevails that directors represent the entire corporation and not special interests, the corporate statutes allow for election of directors by class of shareholders and, through cumulative voting, by minority shareholders. Directors chosen by a class of shares are expected to advance programs and policies that would increase the value of those shares, even if shares of another class are disadvantaged.[14] This conflict between representative election and general duties under English law was aptly summarized by Professor Gower as follows:

> The rule that directors are supposed to have regard primarily to long term interests of members and employees may also pose difficulties for directors who are appointed by a particular class of security holders. The obvious intention is that then they shall pay particular attention to the interests of that class whether that be of members or creditors. Yet this, it seems, they must not do. This indeed seems to require them to "live in an unreal region of detached altruism and to act in a vague mood of ideal abstraction from obvious facts."[15]

Close Corporations and Venture Capital

In close corporations, the shareholders negotiate their proportionate interests and expect their nominee directors to carry out the wishes of the shareholder selecting them. Early cases struck down shareholder agreements restricting director discretion. *O'Neal's Close Corporations* states:

> Many of the early decisions which invalidated shareholders' agreements limiting the directors' powers or tending to influence their judgment appear to have been based in part at least on an unrealistic idea that directors in making corporate decisions act independently and without regard to the desires of the principal shareholders. Actually, of course, the facts are otherwise. Directors normally follow the wishes of the shareholders that elect them, and there appears to be no inherent

> impropriety in their carrying out the wishes of controlling shareholders as long as minority interests are not unfairly affected. In close corporations in particular, majority shareholders usually exercise effective control over the decisions of directors.[16]

In a close corporation involving two families, shareholder directors would be surprised to learn that there are supposed to be limits on their ability to follow their individual family interests. The traditional corporate model does not fit the expectations of the parties in close corporations.

The position of the venture capital representative director highlights the difficulties in the traditional corporate model analysis. Venture capitalists typically obtain board representation as part of their investment requirements. The directors selected usually take an active role in the portfolio company in order to add their financial skills and protect and promote the investment of the sponsor, which often itself is a managed fund. In particular, the need for an exit strategy for a venture capitalist can conflict with the desire of the founders to preserve their control and positions. Even after a portfolio company becomes publicly traded, the representative director will be an active participant and have responsibilities to both the sponsoring fund and the corporation, with possibly different timetable and financial goals than other major shareholders and the public investors.[17]

General Analysis

Although the disparity between the lofty principle of undivided loyalty to the corporation and all of its shareholders and the reality of representative directors is most obvious in close corporations, the rhetoric and reality conflict in many corporate settings. For example, courts recognize a premium attributable to controlling shares precisely because of the power of the controlling shareholder to pick representative directors and control corporate policy for the benefit of the controlling person.[18] The representative director necessarily has modified obligations to the controlled corporation.

The examples given above show that the corporate model of pristine director disinterest conflicts with the need for representation of shareholder and other interests. The underlying support for insisting on independence is the need for the board to pursue the best interests of the corporate business. Weakening the pursuit of corporate profit in the interest of a constituency could make the corporation less efficient and prejudice the other constituencies in the enterprise. On the other hand, the representative rights of preferred stock and venture capital investors are bargained for protection that helps the corporation attract capital. The solution would be to reconcile the model of disinterest with the necessary balance of relations between the interested parties. Although the standard corporate model is simplistic and unworkable as a rigid guide, it does reflect the worthy aspirational goal that directors pursue corporate profit for the primary benefit of all shareholders.

There are two basic directions from which to approach the representative director problem. At one end of the continuum is the close corporation where courts can recognize the essential contractual relationship between the shareholders and other parties and leave them to their bargains, including expressed or implied shareholder agreements for representative directors who act on behalf of themselves or a sponsor. The basic assumption should be that most close corporation directors are representatives. At that extreme, self interested actions can be bounded by a fairness doctrine which would monitor conduct that reflects an abuse of power that is not within the expected range of the bargain of the shareholders. Minority shareholders would have relief from such abuse under oppression doctrines in many states.

At the other extreme, in the large public corporation, the underlying assumption can be that most directors are to act in the best interests of the corporation in pursuit of corporate profit for the primary benefit of all shareholders. Nevertheless, the participants should be free to negotiate express contractual provisions to modify the model, such as preferred stock nominee director veto rights. These agreements would be constrained by considerations of public policy to prevent extreme distortions of the corporate norm, such as a complete abdication of director duties or a wholesale waiver of loyalty claims.

The parent- partially owned subsidiary corporation situation falls between the two extremes. Here the rhetoric has been the most troublesome. It should be assumed that, like in a close corporation, nominees of a controlling shareholder would act on behalf of the controlling shareholder, and only general fiduciary standards imposed on majority shareholders protect the minority shareholder. Cases such as *Weinberger*, where representative directors were told that they should have disclosed the valuation range that the parent corporation used in a cash-out merger and *McMullin v. Beran*,[19] where the board of an 80.1 percent owned subsidiary was supposed to inject itself into sale negotiations conducted by the parent corporation, would be rejected under this analysis. Such unrealistic holdings clog transactions with self-serving documentation without achieving any special benefit to minority shareholders.

Several recent Delaware cases show that the imposition of *Weinberger* strict "entire fairness" standards on controlling shareholders may be dependent on form rather than fundamental principle. In *Glassman v. Unocol Corp.,*[20]the Supreme Court held that fairness standards did not apply to a short form merger, and in *In Re Siliconix, Inc.*,[21] and *In Re Aquila, Inc.*,[22] the Court of Chancery found that fairness standards did not apply to exchange offers made by controlling shareholders. These cases indicate that statements of strict loyalty requirements of representative directors serving on the board of a controlled subsidiary may only be a formalistic attachment to an idealized corporate model of director independence, without a substantive tie to a duty of the controlling shareholder. A more nuanced approach would look at the position of the representative director in its business context and avoid categorical positions in the parent-subsidiary situation.

A Suggested Approach

Since the rigid duty of loyalty standard was created by courts and is not mandated by any specific statutory provision, the courts can do much to alleviate the problem without additional legislation. The gap between theory and practice can be narrowed by the following steps.

First, courts should recognize the dual responsibilities of representative directors and resist the temptation to promulgate high sounding statements of undivided loyalty.

Second, courts can recognize express authorization of representative status by contract, charter, bylaws or board resolution in appropriate circumstances. For close corporations, provisions like Section 7.32 of the Model Business Corporation Act allow variation of statutory corporate norms by shareholders bounded only by public policy considerations. Since the entire board can be abolished under these provisions, something less that recognizes representative capacity would not violate public policy. The recent addition of Section 122(17) to the Delaware General Corporation Law permitting advance renunciation of corporate opportunities is an example of possible express statutory modifications of broad duty of loyalty principles in response to court positions. Shareholders should be able to contract for director actions to the same extent as they contract for shareholder actions.

Third, representative directors should make full disclosure of their status and the interest of their sponsor. They should recuse themselves from transactions directly involving their sponsors and resign when a continuing conflict is unavoidable. In a controlled corporation situation, the actions of the representative director should be treated in the same manner as actions of controlling shareholders, including a general fiduciary duty to act fairly toward the minority. In effect, the presence of representative directors in a parent-subsidiary merger can be disregarded as a court considers the actions of the parent and the protections afforded minority shareholders.

Finally, directors should be free to transmit information to their sponsors. For example, a bank representative on the board of a bank customer should be free to convey financial information concerning the customer to the bank as well as expressing a lender's perspective in connection with corporate policy. When, however, the corporation is considering changing banks or renegotiating the loan, or is insolvent, the director should not participate in the deliberations or receive detailed information concerning the problem.

The foregoing proposals recognize that representative directors are a useful and legitimate part of corporate life. While courts now usually reach the right result by sustaining actions of representative directors as exercises of protected business judgment, they must stretch the conditions of the business judgment rule requiring independence and a belief in the best interests of the corporation. A more direct analysis would be to proceed on a contractual analysis and find that the parties agreed that the director might act as a representative, while recognizing the differences between close and public corporations and the special problems of a parent-subsidiary relationship. To summarize the proposed conclusion: a representative director acts in a dual capacity with duties to both the corporation and the sponsor, is expected to act as an intermediary, is a representative of the sponsor, and may act freely on behalf of the sponsor unless the action directly injures the corporation or clearly is unfair to minority shareholders. In contrast, the traditional corporate model confuses the role of the representative director and does not recognize the important work that the representative director performs in the corporate system.

Notes

[1] ABA Comm. on Corp. Laws, Corporate Director's Guidebook (Section of Business Law 2d Ed. 1994), reprinted in 49 Bus. Law. 1243, 1250 (1994). The third edition of the Corporate Director's Guidebook does not repeat the categorical formulation, but expresses the same general view of the duty of loyalty. 56 Bus. Law. 1571, 1582 (2001). The ABA Committee on Corporate Laws Guidelines for the Unaffiliated Director of the Controlled Corporation also state that all directors have the same duties to the corporation and all of its shareholders. 45 Bus. Law. 429 (1989). The presumption of director independence helped the defendants in *United States v. Byrum*, 408 U.S. 125 (1972) (decedent controlled 50 percent of shares), *Aronson v. Lewis*, 473 A.2d 805 (Del. 1984) (demand not excused even though controlling shareholder selected directors), and *Phillips v. Insituform of North America, Inc.*, 1987 Del. Ch. LEXIS 474, 13 Del. J. Corp. L. 774 at 790 (right to designate majority of board does not carry special duty to class selecting directors).

[2] 5 A.2d 503, 510 (Del. 1939).

[3] 457 A.2d 701 (Del. 1983).

[4] Id. at 710. *See also* as to dual board memberships and designated directors, 1 R. F. Balotti & J. Finkelstein, The Delaware Law of Corporations and Business Organizations, 3d Ed., § 4.38.

[5] *See Zeitlin v. Hanson Holdings*, Inc. 48 N.Y.2d 684, 397 N.E.2d 389 (1979); Cox, Hazen, O'Neal, Corporations §§ 12.1, 13.19.

[6] *See* Drexler, Black & Sparks, Delaware Corporation Law & Practice, § 15.11.

[7] *See generally*, Balotti, op. cit. § 4.35.

[8] 629 F.2d 287 (1980).

[9] 280 A.2d 717 (Del. 1971).

[10] Bogen, Directors' Duties to *Which* Stockholders,? Corp. Governance Adviser, December 1992/January 1993 p. 24; *see generally* as to special duty of loyalty problems, Balotti and Finkelstein, The Delaware Law of Corporations and Business Organizations, 3rd Ed. § 4.38. In *Alderstein v. Wertheimer*, 2002 Del. Ch. LEXIS 13, the court suggested that there is a duty of loyalty to a controlling shareholder (n. 35).

[11] International Union, United Automobile, Aerospace & Agriculture Implement Workers of America v. Dorsey, Circuit Court for Washtenaw County, Michigan, Case No. 97-8442-CB, Defendants Cross-Claim ¶ 90(i).

[12] *See* Conard, The Supervision of Corporate Management: A Comparison of Developments in the European Community and United States Law, 82 Mich. Law Rev. 1459 (1984) at 1485.

[13] Fraser, Worker Participation in Corporate Government: The U.A.W. Chrysler Experience, 58 Chi. Kent L. Rev. 949 (1982). For a survey of the experiences of union nominated directors during the 1980s, see Hunter, Can Strategic Participation be Institutionalized? Union Representation on American Corporate Boards, 51 Ind. and Lab. Rel. Rev. 557 (1998).

[14] The natural expectation of class representation can conflict with the idealized model. In *Zahn v. Transamerica Corp.*, 162 F.2d 36 (3rd Cir. 1947), the court said that a "puppet-puppeteer" relationship existed with the principal shareholder that caused a breach of fiduciary duty in calling shares of another class. Subsequent proceedings, however, found the call rightful. *Speed v. Transamerica Corp.*, 235 F2d 369 (3rd Cir. 1956).

[15] Gower, Principles of Modern Company Law, 5th Ed. 1992, quoting Mills v. Mills (1938) 60 C.L.R. 150 (Aust. H. C.) at 164. In partial recognition of the representative director problem, English company law applies director obligations to a "shadow director," defined as "any person in accordance with whose directions or instructions the directors of the company are accustomed to act." Companies Act of 1985, § 741(2).

[16] O'Neal and Thompson, O'Neal's Close Corporations, 3 Ed., § 5.20.

[17] The representative capacity of the director is indirectly recognized in determining eligibility for service on an audit committee. NASDAQ interpretations of independence could disqualify employees of a 25 percent shareholder such as a venture capital fund. Anne G. Plimpton, The Search for the Ultimate Committee Member, Insights volume 15, number 11, November 2001, page 6.

[18] *See Paramount Communications, Inc. v. QVC Network, Inc.*, 637 A.2d 34 (Del. 1994).

[19] 765 A.2d 910 (Del. 2000). Similarly, *In Re: Digex, Inc. Shareholders Litigation*, (2000 Del. Ch. LEXIS 171 (Dec. 13, 2000), the court found that representatives of a majority shareholder breached their fiduciary duties by waiving the application of Delaware section 203 to allow the majority shareholder to sell shares.

[20] 777 A.2d 242 (Del. 2001).

[21] 2001 Del. Ch. LEXIS 83 (June 19, 2001)

[22] 2002 Del. Ch. LEXIS 5 (Jan. 3, 2002).