

# WHEN THE GOVERNMENT IS THE CONTROLLING SHAREHOLDER: IMPLICATIONS FOR DELAWARE

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## ABSTRACT

*When the federal government is the controlling shareholder, the doctrine of sovereign immunity transforms the legal structures of accountability. Procedurally, the government and its agents can only be sued in federal court. Substantively, claims must be brought within one of the statutory waivers of sovereign immunity (the Federal Tort Claims Act, the Tucker Act, or the Administrative Procedure Act). Although in the right circumstances plausible claims could be brought in Delaware against the directors of a government-controlled Delaware corporation, we argue that Delaware should avoid a confrontation with Washington, and that the best way to do so is to take advantage of the flexibility provided by Delaware Court of Chancery Rule 19.*

## I. INTRODUCTION

For the first time in living memory, the federal government owns controlling stock positions in major private corporations. The United States Treasury owns 60% of General Motors (GM),<sup>1</sup> 56% of GMAC,<sup>2</sup> 26% of Citigroup,<sup>3</sup> and 77.9% of American International Group (AIG),<sup>4</sup> all Dela-

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<sup>1</sup>See Bill Vlasic & Nick Bunkley, *Obama Is Upbeat for G.M. Future on a Day of Pain*, N.Y. TIMES, June 2, 2009, at A1.

<sup>2</sup>Binyamin Appelbaum, *U.S. to Give \$3.6 Billion More in Aid to GMAC; Move Makes Government the Majority Owner of Troubled Auto Lender*, WASH. POST, Dec. 31, 2009, at A1.

<sup>3</sup>David Enrich & Damian Paletta, *Discord Behind TARP Exits*, WALL ST. J., Dec. 19, 2009, <http://online.wsj.com/article/SB10001424052748703323704574602552053952422.html>; Michael Corkery, *The Good, Bad, and Ugly of Citigroup's Botched Stock Sale*, WALL ST. J., Dec. 17, 2009, <http://blogs.wsj.com/deals/2009/12/17/the-good-bad-and-ugly-of-citigroups-botched-stock-sale/>.

<sup>4</sup>Andrew Ross Sorkin & Mary Williams Walsh, *A.I.G. Reports Loss of \$61.7 Billion as U.S. Gives More Aid*, N.Y. TIMES, Mar. 2, 2009, <http://www.nytimes.com/2009/03/03/business/03aig.html?pagewanted=1>.

ware corporations. In addition, it owns 79.9% of Fannie Mae and 79.9% of Freddie Mac, both of which are government-sponsored enterprises.<sup>5</sup>

When the government is the controlling shareholder, the accountability structures are fundamentally transformed both procedurally and substantively: any claims against the controlling shareholder are adjudicated in federal court under federal law, with very uncertain results. Although claims against officers and directors of Delaware corporations who are not federal employees can be adjudicated in the Delaware state courts under ordinary principles of Delaware corporate law, doing so would put Delaware in a difficult position. In this article, we argue that in such circumstances, Delaware's optimal strategy is to "duck" such disputes, and we provide a roadmap for how Delaware should do so.<sup>6</sup>

A quick glance through the financial pages provides numerous examples of government interference in decisions that traditionally have been viewed as private management responsibility. A few illustrations will suffice. In the wake of the federal bailout of Chrysler and GM, there was congressional pressure to prevent the closure of GM and Chrysler dealers.<sup>7</sup> The Treasury, beginning with AIG's bonus scandal and continuing through the work of the compensation "czar" Kenneth Feinberg, has been heavily involved in executive compensation in bailed-out institutions.<sup>8</sup> There has been continual pressure on government-supported banks, including Citigroup, to increase lending to small businesses and to restructure loans to consumers.<sup>9</sup>

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<sup>5</sup>Louise Story, *New Aid for Fannie and Freddie*, N.Y. TIMES, Dec. 25, 2009, at B1. Through its position as a creditor, the federal government also controls Bank of America. See Appelbaum, *supra* note 2 (noting Bank of America's efforts to repay government aid).

<sup>6</sup>To examine an even broader set of issues raised by government ownership, see generally J.W. Verret, *Treasury Inc.: How the Bailout Reshapes Corporate Theory and Practice* (George Mason Law & Econ. Research Paper No. 09-43, 2009), available at <http://ssrn.com/abstract=1461143>.

<sup>7</sup>Peter Whoriskey & Kendra Marr, *Senators Blast Automakers Over Dealer Closings; GM, Chrysler Defend Massive Shutdowns*, WASH. POST, June 4, 2009, at A15.

<sup>8</sup>See, e.g., Carl Hulse & David M. Herszenhorn, *A.I.G. and Wall St. Confront Upsurge of Populist Fury*, N.Y. TIMES, Mar. 20, 2009, at A1; see also Brady Dennis, *AIG Plans Millions More in Bonuses; Troubled Insurer Is in Talks with U.S. Over \$250 Million*, WASH. POST, July 11, 2009, at A1 (discussing post-bailout regulation of AIG executive bonuses); Liam Plevin & Deborah Solomon, *AIG Seeks Clearance to Release Bonuses*, WALL ST. J., July 10, 2009, at C1 (discussing the same).

<sup>9</sup>See, e.g., Christi Parsons & Peter Nicholas, *"We Will Rebuild, We Will Recover,"* L.A. TIMES, Feb. 25, 2009, at A1 (quoting President Obama as saying banks "will have to clearly demonstrate how taxpayer dollars result in more lending for the American taxpayer"); see also Ross Kerber, *Banks Draw Heavy Fire from Capitol Hill; Legislators Lash Out, Saying Financial Firms Haven't Met Their End of the Bailout Bargain*, BOSTON GLOBE, Nov. 14, 2008, at B7; Ross Kerber, *Businesses in N.E. Say Lenders Too Strict Terms Toughen, Despite Flow of Federal*

All of this is only the tip of the iceberg. It reflects instances of federal pressures that have come to light in the short period of time since the government obtained control of these various companies. If government control is not quickly dismantled, these instances are bound to multiply. Perhaps more importantly, the examples above do not reflect any of the more subtle pressures on companies and their executives that have not yet made it into the press.

How did we get here? More quickly than one would have thought imaginable. It started in March 2008 with the Treasury and Federal Reserve's (Fed) ad hoc facilitation of the rescue of Bear Stearns by J.P. Morgan Chase.<sup>10</sup> It continued with the summer 2008 rescue of Fannie Mae and Freddie Mac.<sup>11</sup> It reached gale force in the September 2008 bailout of AIG and the October 2008 enactment of the Emergency Economic Stabilization Act of 2008 (EESA), which resulted in the Troubled Assets Relief Program (TARP) that provided investments in Citigroup, Bank of America, and numerous other banks.<sup>12</sup> It culminated in the December 2008 rescue of GMAC,<sup>13</sup> and the spring 2009 bailouts of GM and Chrysler.<sup>14</sup>

In the course of these high speed rescues, the Treasury acquired stock (both voting and nonvoting) and warrants in numerous public companies. To make things even more difficult, the government response was performed enacted in haste with shifting goals and minimal guidance on how ownership positions should be held or managed. Although there is no evidence that the *purpose* was to exercise control, the rescues have provided numerous opportunities for the exercise of control. Stock ownership (especially controlling stakes) creates the *power* to interfere, and numerous formal *opportunities* to do so (on every issue that must be approved by the shareholders at the annual meeting). Moreover, stock ownership creates

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*Funds*, BOSTON GLOBE, Feb. 21, 2009, at A1.

<sup>10</sup>For more details, see generally Marcel Kahan & Edward Rock, *How to Prevent Hard Cases from Making Bad Law: Bear Stearns, Delaware, and the Strategic Use of Comity*, 58 EMORY L.J. 713 (2009) (analyzing how Delaware avoided muddying its corporate law and injecting itself into international economic policy by deferring tough legal questions to New York courts).

<sup>11</sup>See Story, *supra* note 5 (detailing federal intervention to save Fannie Mae and Freddie Mac).

<sup>12</sup>See Matthew Ericson et al., *Tracking the \$700 Billion Bailout*, N.Y. TIMES, <http://projects.nytimes.com/crediterisis/recipients/table> (providing a comprehensive list of recipients of the TARP funds). For a detailed review of these events, see generally ANDREW ROSS SORKIN, *TOO BIG TO FAIL: THE INSIDE STORY OF HOW WALL STREET AND WASHINGTON FOUGHT TO SAVE THE FINANCIAL SYSTEM—AND THEMSELVES* (2009).

<sup>13</sup>See Appelbaum, *supra* note 2 (discussing the federal government's assistance of GMAC).

<sup>14</sup>See Peter Whoriskey & Kendra Marr, *GM, Chrysler Seek Billions More in Aid; Firms to Cut 50,000 Jobs, Drop 6 Brands*, WASH. POST, Feb. 18, 2009, at A1.

virtually unlimited informal opportunities for various governmental actors to exert influence and reduces the political cost of interference by diminishing its salience and visibility. Helpful suggestions, comments, or advice to the CEO about how to run the company, made by a Treasury official or an important member of Congress at a cocktail party or in a telephone conversation, carry an entirely different weight when the government controls 30% to 80% of the company's equity.

In principle, of course, there is nothing wrong with major equity holders influencing the way their companies do business. Yet, as we argue below, the presence of the federal government as a controlling shareholder fundamentally transforms the legal structures of accountability. In this article, we first describe that transformation. We then turn to how it affects Delaware's role in adjudicating intra-corporate disputes and the threats posed to Delaware's position by federal government involvement. Finally, we discuss how Delaware can "duck."

## II. WHEN THE GOVERNMENT IS THE CONTROLLING SHAREHOLDER

### *A. Controlling Shareholders Under Delaware Law*

To understand the transformation wrought by government control, consider first the Delaware rules when the controlling shareholder is a private individual or firm. Figure 1 provides a basic self-dealing hypothetical: the fictional Victor Black owns controlling interests of 60% in Company A and 80% in Company B, and uses his control to lean on Company A to enter into a contract on preferential terms with Company B. Victor Black's conflict of interest is clear: he benefits by siphoning money from Company A (in which he only has a 60% interest) to Company B (in which he has an 80% stake).

## Our basic hypo: self dealing

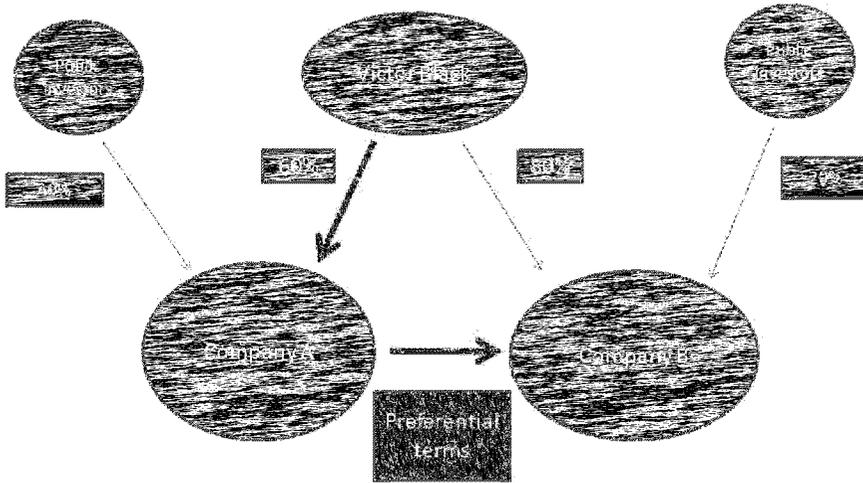


Figure 1.

The Delaware law governing related party transactions is well developed. The threshold question is whether Black has control. If Black controls a majority of the voting power, he is deemed to be a controlling shareholder.<sup>15</sup> If he has a significant but less than majority stake, he is considered a controlling shareholder if he actually controls the corporate decision making.<sup>16</sup> In our hypothetical, Black would be a controlling shareholder of Company A as well as Company B. As a controlling shareholder, he has, under Delaware law, fiduciary duties to noncontrolling shareholders.<sup>17</sup> Delaware law then examines related party transactions under the duty of loyalty rubric, and applies an "entire fairness" standard.<sup>18</sup> "Entire fairness" is understood to encompass "fair price" and "fair dealing."<sup>19</sup>

<sup>15</sup>See generally 1 EDWARD P. WELCH ET AL., *FOLK ON THE DELAWARE GENERAL CORPORATION LAW* § 151.5.1, at GCL-V-34 (5th ed. 2008) (citing, *inter alia*, *In re Tri-Star Pictures, Inc. Litig.*, 634 A.2d 319, 328 (Del. 1993); *Ivanhoe Partners v. Newmont Mining Corp.*, 535 A.2d 1334, 1344 (Del. 1987)).

<sup>16</sup>*Kahn v. Lynch Comm'n Sys., Inc.*, 638 A.2d 1110, 1114 (Del. 1994).

<sup>17</sup>See *id.* at 1113-14.

<sup>18</sup>*Id.* at 1115-17.

<sup>19</sup>*Weinberger v. UOP, Inc.*, 457 A.2d 701, 711 (Del. 1983).

In applying the entire fairness standard to related party transactions, Delaware encourages the use of procedural devices such as the involvement of independent directors in negotiating and approving such transactions or ratification by disinterested shareholders. When such devices are used properly—e.g., if the directors are truly independent and function effectively and if shareholders receive full disclosure and their vote is uncoerced—they shift the burden of proof with respect to whether the transaction was entirely fair to the plaintiff challenging the transaction.<sup>20</sup> When a violation of the duty of loyalty is found, the remedies include an injunction and damages, measured by reference to arm's-length market transactions.<sup>21</sup>

In a case like Figure 1, a derivative suit alleging breach of the duty of loyalty would likely be filed in Delaware Chancery Court. Demand would probably be excused. Ordinarily, Delaware courts apply to the so-called *Aronson* test to determine demand futility.<sup>22</sup> Under *Aronson*, a derivative plaintiff must allege specific facts that create a reasonable doubt as to whether (1) a majority of the board is disinterested or independent or (2) the challenged transaction was the product of the board's valid exercise of business judgment.<sup>23</sup>

Given the presence of a controlling shareholder, there will be many instances in which a majority of the board members either have an interest in the transaction (e.g., because they represent the controlling shareholder) or lack sufficient independence (e.g., because they work for the controlling shareholder or have other business relationships with the controlling shareholder).<sup>24</sup> In these cases, demand will be excused under the first prong

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<sup>20</sup>See, e.g., *Lynch Comm'n*, 638 A.2d at 1117. There is some ambiguity in the Delaware case law. Compare *Kahn v. Tremont Corp.*, 694 A.2d 422, 428 (Del. 1997) (stating, in context of self-dealing transaction involving controlling shareholder, that approval by properly functioning committee of independent directors would shift burden on entire fairness standard to plaintiffs), with *Orman v. Cullman*, 794 A.2d 5, 20 n.36 (Del. Ch. 2002) (stating, in context of merger involving material conflict of interest on part of controlling shareholder, that entire fairness applies *ab initio* only to freeze-out mergers with controlling shareholders). *Orman v. Cullman* thus raises the possibility that entire fairness does not apply to *all* transactions involving controlling shareholders, but only to a subset, namely, freeze-out mergers.

<sup>21</sup>See *Bomarko, Inc. v. Int'l Telecharge, Inc.*, 794 A.2d 1161, 1184 (Del. Ch. 1999) ("In determining damages, the court's powers are complete to fashion any form of equitable and monetary relief as may be appropriate." (quoting *Weinberger*, 457 A.2d at 714)).

<sup>22</sup>*Aronson v. Lewis*, 473 A.2d 805, 814-15 (Del. 1984).

<sup>23</sup>*Id.*

<sup>24</sup>See *McPadden v. Sidhu*, 964 A.2d 1262, 1270-73 (Del. Ch. 2008) (excusing demand where the board appointed an overseer who solicited sham bids and ultimately awarded a contract to his own company). *But see* *Beam v. Stewart*, 845 A.2d 1040, 1051-52 (Del. 2004) (refusing to excuse demand where controlling shareholder and founder exercised 94% voting power and had

of *Aronson*. Perhaps more importantly, if the self-dealing transaction involving a controlling shareholder is substantively analyzed under the entire fairness test—and thus *not* protected by the business judgment rule—there is a good argument that demand is excused under the second prong of *Aronson*.<sup>25</sup> Such an argument would rest on the fact that, since the transaction is subject to entire fairness review by the court, there is a reasonable doubt that the transaction was the product of the board's valid business judgment.

Moreover, independent directors' role in assessing a self-dealing transaction is closely analogous to independent directors' role in deciding whether to have the company bring a lawsuit against insiders. In both instances, they make decisions regarding matters in which they do not have a direct interest, but in which other board members do. Likewise, a conclusion that a transaction is protected by the business judgment rule is analogous to a conclusion that the company should not bring a lawsuit: in both instances, the court does not review the substance of the underlying decision or transaction. In a self-dealing transaction with a controlling shareholder, Delaware law is clear that the transaction is subject to entire fairness even if approved by independent directors. In imposing this standard, rather than the business judgment rule, Delaware cases make clear that independent directors are not sufficiently trusted to dispense with *substantive* review by the court (as the effect of approval by independent directors is *not* reinstatement of the business judgment rule). Thus, it would make sense if, in applying the relevant *procedural* standard, courts likewise did not defer to independent directors (as they would if demand were not excused in such cases). Otherwise, the result would be the somewhat odd structure in which the court says that self-dealing transactions with controlling shareholders are sufficiently suspect that they are *always* evaluated under entire fairness, but that such cases will *never* make it to court at all if a board (with a majority of independent directors) decides not to pursue it.

If demand is excused, the court would independently evaluate both the financial terms of the transaction and the process leading to the transaction and determine whether they comply with the entire fairness standard. In short, if the transaction is indeed unfair, there is a significant likelihood that the plaintiffs would succeed in either enjoining the

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close personal friendships with board members).

<sup>25</sup>To our knowledge, no case directly endorses or rejects the proposition that demand is automatically excused under the second prong of *Aronson* for self-dealing transactions with controlling shareholders that, under *Kahn v. Lynch Commc'n*, are always subjected to entire fairness review.

transaction or recovering damages. The robust protections provided by the duty of loyalty is a function of relatively clear rules enforced by private injunctive and damages actions.

### B. *Suing the Government as Controlling Shareholder*

When the federal government is the controlling shareholder, this structure of accountability is transformed. Consider a slightly modified hypothetical: substitute the Treasury for the fictional Victor Black, the fictional Detroit Motors Acceptance Corporation (DMAC) for Company A and the fictional Detroit Motors (DM) for Company B, as in Figure 2. Suppose, further, that the Treasury leans on DMAC to provide financing to DM, and its dealers and customers, on preferential terms. What sort of claims would the noncontrolling shareholders have?

## Our basic hypo: self dealing

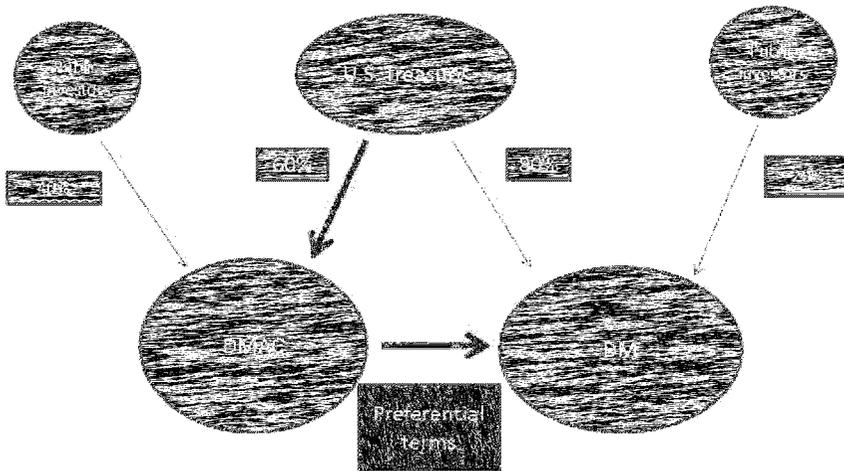


Figure 2.

Consider, first, claims against the controlling shareholder, the Treasury. An initial hurdle is "sovereign immunity," the doctrine according to which the "sovereign" (i.e., the federal government) may only be sued to

the extent that it gives its permission.<sup>26</sup> This has both procedural and substantive implications.

Procedurally, the law is clear that the federal government and its agents may only be sued in federal district court or the court of federal claims, depending on the cause of action.<sup>27</sup> Any claims that are brought in state court may be removed to the appropriate federal court.<sup>28</sup>

Substantively, only claims within the federal government's waivers of sovereign immunity may be brought. There are three main waivers: the Federal Tort Claims Acts (FTCA),<sup>29</sup> the Tucker Act,<sup>30</sup> and the Administrative Procedure Act.<sup>31</sup> The FTCA, as its name indicates, waives sovereign immunity with respect to tort actions.<sup>32</sup> The Tucker Act waives immunity with respect to claims against the United States "founded either upon the Constitution, or any Act of Congress or any regulation of an executive department, or upon any express or implied contract with the United States, or for liquidated or unliquidated damages in cases not sounding in tort."<sup>33</sup> The Administrative Procedure Act provides for injunctive relief against agency action, but does not provide for damages.<sup>34</sup>

Trying to bring a breach of fiduciary duty action against the government as a controlling shareholder raises a host of fascinating issues. Is a breach of the duty of loyalty a tort for the purposes of the FTCA?<sup>35</sup> Even if the FTCA applies, would the government conduct fall within the "discretionary functions" exception?<sup>36</sup> As we discuss at length elsewhere, a

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<sup>26</sup>*E.g.*, *United States v. Mitchell*, 463 U.S. 206, 212 (1982) ("It is axiomatic that the United States may not be sued without its consent and that the existence of consent is a prerequisite for jurisdiction.").

<sup>27</sup>28 U.S.C. § 1346(a) (2006).

<sup>28</sup>*Id.* § 1442(a).

<sup>29</sup>*Id.* § 2674.

<sup>30</sup>*Id.* § 1491(a)(1); *see also Mitchell*, 463 U.S. at 212 ("[W]e conclude that by giving the Court of Claims jurisdiction over specified types of claims against the United States, the Tucker Act constitutes a waiver of sovereign immunity with respect to those claims." (footnote omitted)).

<sup>31</sup>5 U.S.C. § 702 (2006).

<sup>32</sup>28 U.S.C. § 2674 ("The United States shall be liable [for tort] . . . to the same extent as a private individual under like circumstances, but shall not be liable for interest prior to judgment or for punitive damages.").

<sup>33</sup>*Id.* § 1491(a)(1).

<sup>34</sup>5 U.S.C. § 702 (permitting "relief other than money damages").

<sup>35</sup>*See generally* Peter Birks, *The Content of Fiduciary Obligation*, 34 *ISR. L. REV.* 3 (2000); Roy Ryden Anderson & Walter W. Steele, *Fiduciary Duty, Tort and Contract: A Primer on the Legal Malpractice Puzzle*, 47 *SMU L. REV.* 235 (1994).

<sup>36</sup>Section 2680(a) of title 28 of the United States Code states the FTCA waiver of sovereign immunity shall not extend to "[a]ny claim based upon . . . the exercise or performance or the failure to exercise or perform a discretionary function or duty on part of a federal agency or an employee of the Government, whether or not the discretion involved be abused." 28 U.S.C.

plaintiff's chances under the FTCA, even for a clear cut violation of the duty of loyalty, would be highly uncertain and not the sort of case that a rational lawyer would take on a contingent fee.

The Tucker Act issues are every bit as complex. The Tucker Act does not, itself, create any substantive rights.<sup>37</sup> In our hypothetical, would there be an independent basis for a claim? Although there are some plausible potential claims, success would be uncertain and would depend on an extension of current law.

Finally, under the Administrative Procedure Act, a plaintiff would face a variety of challenges that derive from the odd situation in which the government is acting in a private setting without either accepting applicable Delaware law or explicitly opting out. A plaintiff could argue that federal governmental actions that are inconsistent with Delaware law are "not in accordance with law" and thus invalid under § 706.<sup>38</sup> In response, the government could argue that § 701(a)(2) precludes judicial review when "agency action is committed to agency discretion by law" and that the EESA, which authorized the TARP program, did just that.<sup>39</sup> As with the other federal theories, while there are some potential claims, all have uncertain prospects and would require extension of current law.

### C. *An Alternative Strategy: Suing the Officers and Directors*

Delaware's controlling shareholder jurisprudence has two pillars: controlling shareholders owe duties to noncontrolling shareholders in certain circumstances,<sup>40</sup> and the officers and directors of controlled corporations, however they are elected, owe duties to the corporation and *all* its shareholders.<sup>41</sup> When a controlling shareholder uses its power to engineer a conflicted transaction, directors play a special role in protecting the noncontrolling shareholders in the Delaware system.<sup>42</sup> In this section, we consider whether there would be plausible claims against the directors of DMAC.

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§ 2680(a) (2006).

<sup>37</sup>United States v. Navajo Nation, 129 S. Ct. 1547, 1551 (2009).

<sup>38</sup>5 U.S.C. § 706(2)(A) (2006).

<sup>39</sup>*Id.* § 701(a)(2).

<sup>40</sup>*See* Cinerama, Inc. v. Technicolor, Inc., Civ. A. No. 8358, 1991 WL 111134, at \*19 (Del. Ch. June 24, 1991), *aff'd in part and rev'd in part*, 634 A.2d 345 (Del. 1993), *reprinted in* 17 DEL. J. CORP. L. 551, 585 (1992) ("[W]hen a shareholder, who achieves power through the ownership of stock, exercises that power by directing the actions of the corporation, he assumes the duties of care and loyalty of a director of the corporation.").

<sup>41</sup>*See, e.g.*, Emerald Partners v. Berlin, 787 A.2d 85, 91 (Del. 2001) ("[T]he shareholders of a Delaware corporation are entitled to rely upon their board of directors to discharge each of their . . . fiduciary duties at all times.").

<sup>42</sup>Kahn v. Lynch Comm'n Sys., Inc., 638 A.2d 1110, 1120-21 (Del. 1994).

Assume that DMAC has seven directors, two of whom were nominated by the Treasury (but are not Treasury employees), and all of whom were elected by a plurality that included the Treasury votes. Assume that the other five directors were not selected by the Treasury.

Suppose, now, that the board, after the two Treasury-nominated directors report the Treasury's views, decides unanimously to loan money on preferential terms to DM, its customers, and dealers. What can the shareholders do?

The starting point under Delaware law is that all directors, however they make it to the boardroom, are expected to attend to the interest of the corporation and all of its shareholders: "the law demands of directors . . . fidelity to the corporation and all of its shareholders and does not recognize a special duty on the part of directors elected by a special class to the class electing them . . ."<sup>43</sup> The Delaware Supreme Court made it clear in *Weinberger v. UOP* that designees of a controlling shareholder are not thereby insulated from their duties:

[The controlling shareholder] cannot escape the effects of the conflicts it faced, particularly when its designees on [the] 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. The requirement of fairness is unflinching in its demand that where one stands on both sides of a transaction, he has the burden of establishing its entire fairness, sufficient to pass the test of careful scrutiny by the courts.

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

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<sup>43</sup>*Phillips v. Insituform of N. Am., Inc.*, Civ. A. No. 9173, 1987 WL 16285, at \*10 (Del. Ch. Aug. 27, 1987), reprinted in 13 DEL. J. CORP. L. 774, 790 (1988); Comm. on Corporate Laws, ABA Section of Bus. Law, *Guidelines for the Unaffiliated Director of the Controlled Corporation*, 45 BUS. LAW. 429, 430 (1989) (noting that "affiliated and unaffiliated directors alike represent all of the shareholders" and stating that "[a]ll directors have the same duties to the corporation and to all of its shareholders"); E. Norman Veasey & Christine T. Di Guglielmo, *How Many Masters Can a Director Serve? A Look at the Tensions Facing Constituency Directors*, 63 BUS. LAW. 761, 766 (2008).

directors of two corporations, one of whom is parent and the other subsidiary, owe the same duty of good management to both corporations . . . .<sup>44</sup>

But this general principle merely frames the inquiry. *Weinberger* itself conditioned this strong statement of duty with phrases like "[g]iven the absence of any attempt to structure this transaction on an arm's-length basis" and "particularly when its designees on [the] board did not totally abstain from participation in the matter" and "in the absence of an independent negotiating structure or the directors' total abstention from any participation in the matter."<sup>45</sup> We now know that each of these conditions has, in fact, been used to shield conflicted directors and transactions.<sup>46</sup>

In the decision to loan money on preferential terms to DM, its customers, and dealers, the Treasury obviously had a conflict of interest. It is less obvious that any of the directors did. The five "independent" directors, by hypothesis, do not also serve as directors of DM, and are also presumptively independent of the Treasury. The two Treasury-designated directors, by contrast, may face a conflict, depending on their other connections, if any, with the Treasury.

So let's fill out the fact pattern a bit. Suppose that the board discussion proceeds along the following lines: The two Treasury-designated directors explain to the board how important this transaction is to the Treasury and the public interest. The other directors, in their discussion of the issue, take seriously the Treasury's concerns, and, moreover, discuss in depth the value to DMAC of maintaining strong and friendly relations with DMAC's controlling shareholder, who also plays a regulatory role. After detailed discussion, the board unanimously decides to make the loans.

In these circumstances, what are the chances that the board members face monetary liability? The independent directors, as described, have no direct financial interest in the transaction, and DMAC undoubtedly has a section 102(b)(7) exculpatory provision. To be insulated from liability under section 102(b)(7), however, they must also have acted in good faith.<sup>47</sup>

As the Delaware Supreme Court recently held, lack of good faith may be

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<sup>44</sup>*Weinberger v. UOP, Inc.*, 457 A.2d 701, 710 (Del. 1983) (citations omitted).

<sup>45</sup>*Id.* at 710-11 (citation omitted).

<sup>46</sup>*See, e.g., Kahn v. Lynch*, 638 A.2d at 1117 ("[An] independent bargaining structure, while not conclusive, is strong evidence of the fairness' of a merger transaction." (quoting *Rosenblatt v. Getty Oil Co.*, 493 A.2d 929, 938 n.7 (Del. 1985))).

<sup>47</sup>*See Stone v. Ritter*, 911 A.2d 362, 367 (Del. 2006) ("[A section 102(b)(7) provision] can exculpate directors from monetary liability for a breach of the duty of care, but not for conduct that is not in good faith or a breach of the duty of loyalty.").

shown where "the fiduciary intentionally acts with a purpose other than that of advancing the best interests of the corporation."<sup>48</sup> If evidence can be adduced to show that the board members realized that making the loans was not in the best interest of DMAC and only approved the loans because of the pressure exerted by the Treasury and its nominees, they arguably lacked good faith and could face monetary liability. The same would be true, *a fortiori*, for the directors nominated by the Treasury.

On the other hand, the directors could argue that, given the precarious position of DMAC, its vulnerability to governmental regulation, and its dependence on future bailouts from the Treasury, it is in the best interest of DMAC to stay on good terms with the government, even if this means DMAC needs to make loans that—analyzed without regard to these factors—are not in best interest of DMAC.

Whether the Delaware courts would (and should) accept such arguments is doctrinally unresolved. In effect, it amounts to the directors arguing that they may, in good faith, approve a detrimental transaction because the controlling shareholder has the power to retaliate and inflict even worse damage on the corporation. A similar argument (in a case involving a private controlling shareholder) was rejected by the Delaware Supreme Court in *Kahn v. Lynch Communication Systems, Inc.*<sup>49</sup> In that case, however, the court merely held that the approval of directors that were so motivated did not constitute an effective cleansing act (and thus did not result in shifting the burden of showing entire fairness).<sup>50</sup> The issue of whether the directors so motivated acted in good faith was not before the court. In a decision by the Delaware Court of Chancery—*In re Emerging Communications, Inc. Shareholders Litigation*<sup>51</sup>—the court held that an outside director was not independent and not shielded from liability by section 102(b)(7) because he possessed special expertise that should have led him to conclude that the transaction proposed by a controlling shareholder was unfair.<sup>52</sup> The court concluded that the director was motivated by the potential future business opportunities he could obtain from the controlling shareholder.<sup>53</sup> While neither *Kahn v. Lynch* nor

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<sup>48</sup>*Id.* at 369 (quoting *In re Walt Disney Co. Deriv. Litig.*, 906 A.2d 27, 67 (Del. 2006)).

<sup>49</sup>*See* 638 A.2d at 1113. In this case, the board of directors approved a merger with the corporation's controlling shareholders after the controlling shareholder threatened to proceed with a hostile tender offer at a lower price if the transaction was not approved. *Id.* at 1118.

<sup>50</sup>*See id.* at 1120-21.

<sup>51</sup>No. Civ. A. 16415, 2004 WL 1305745 (Del. Ch. June 4, 2004).

<sup>52</sup>*Id.* at \*35-40.

<sup>53</sup>*Id.* at \*35.

*Emerging Communications* resolves the issue, they show that a potential for personal liability exists, especially for any nonindependent directors.

Note, however, that as long as the Treasury-appointed directors act in good faith, any further claims against them are unlikely to succeed. Specifically, their role in truthfully conveying the Treasury's views cannot be criticized. Surely this is something that the board should know about.<sup>54</sup> Furthermore, even if they vote, their votes were not the but-for cause of the decision; it would have passed whether they voted for it or not.<sup>55</sup>

But even if both the independent and the Treasury-appointed directors are shielded from personal liability by section 102(b)(7), plaintiffs might pursue a case in order to secure an injunction to block the loan and to prohibit future loans. Even this, however, could be a challenge. Let us assume that disinterested directors who decide, after careful deliberation, to favor a controlling shareholder who holds the power of life and death over the company are viewed as acting in good faith, and thus would not have breached their fiduciary duties. Still, the problem remains that it was the demands of the controlling shareholder that placed the board in an impossible position. And, as we saw above, the controlling shareholder in this case seems to be largely beyond the reach of Delaware law.

Suppose, however, that we focus on the transaction itself rather than on the directors, even if the suit is formally against them. Interestingly, and in recognition of the influence that a controlling shareholder exerts whether or not it fills the board of directors with designees, the standard for judging all transactions between a firm and its controlling shareholder is "entire fairness."<sup>56</sup> A conflicted transaction can arguably be enjoined, even if all individual directors are insulated by 102(b)(7) provisions. If, in fact, the terms are preferential or below market, that would provide a strong basis for a claim that the transaction was not entirely fair. Thus, for example, in *Kahn*

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<sup>54</sup>See Veasey & Di Guglielmo, *supra* note 43, at 772.

[S]o long as the constituency directors' representative capacity is transparently disclosed to stockholder and fellow directors, constituency directors could be permitted to advocate the interests of their sponsors. That is, the constituency directors could attempt to persuade the entire board that their sponsors' interest represent or are aligned with the interests of the corporation and all its stockholders.

*Id.*

<sup>55</sup>"[T]he business judgment rule will not be rebutted if the interested directors do not constitute a majority of the directors approving the transaction." *Id.* (citing DEL. CODE ANN. tit. 8, § 144 (2001)); Aronson v. Lewis, 473 A.2d 805, 812, 814 (Del. 1984)).

<sup>56</sup>*Kahn v. Lynch Comm'n Sys., Inc.*, 638 A.2d 1110, 1116-17 (Del. 1994); *Citron v. E.I. Du Pont de Nemours & Co.*, 584 A.2d 490, 502 (Del. Ch. 1990).

*v. Tremont Corp.*,<sup>57</sup> a case involving a conflict of interest transaction between two corporations controlled by Harold Simmons, the Delaware Supreme Court applied the "entire fairness" standard to the transaction and concluded there was a conflict.<sup>58</sup> The court examined director conduct only in determining whether the special committee had acted sufficiently independently to shift the burden of proof.<sup>59</sup> Finally, it seems, we have come up with a plausible theory of attack under Delaware law.<sup>60</sup> Even if the directors acted in good faith, noncontrolling shareholders could plausibly seek to enjoin the preferential contract.

There may be another scenario for how a case could land in the lap of the Delaware judiciary. Suppose that the decision to extend the loans is not made by the board. Rather, the CEO of DMAC may have decided to approve the transaction on his own, after receiving a telephone call from a Treasury official explaining the importance of the loan to the government. Indeed, such types of pressure were reportedly applied to Ken Lewis by Treasury Secretary Henry Paulson, with respect to whether Bank of America should disclose to its shareholders the mounting losses at Merrill Lynch,<sup>61</sup> and to Fritz Henderson by Massachusetts Congressman Barney Frank with respect to whether GM should close a distribution center in Norton, Massachusetts.<sup>62</sup>

As a matter of corporate law, the officers of the company have the authority to approve many transactions without specific board approval.<sup>63</sup> To the extent that the decision to engage in a transaction is made by an officer,

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<sup>57</sup>694 A.2d 422 (Del. 1997).

<sup>58</sup>*Id.* at 432-33.

<sup>59</sup>*Id.* at 428-30.

<sup>60</sup>*But see* Orman v. Cullman, 794 A.2d 5, 27 n. 36 (Del. Ch. 2002) (suggesting that "the automatic requirement of an entire fairness review" is limited "to the narrow class of cases in which there is a controlling shareholder on both sides of a challenged merger").

<sup>61</sup>*See* Liz Rappaport, *Lewis Testifies U.S. Urged Silence on Deal*, WALL ST. J., Apr. 23, 2009, <http://online.wsj.com/article/SB124045610029046349.html> (describing testimony by Ken Lewis, former CEO of Bank of America, regarding the pressure placed on him by government officials not to disclose presumptively material information to the company's shareholders).

<sup>62</sup>*See* Joe Weisenthal, *Barney Frank Intervenes to Keep Open Massachusetts GM Facility*, BUS. INSIDER (ONLINE), June 5, 2009, <http://www.businessinsider.com/barney-frank-intervenes-to-keep-open-massachusetts-gm-facility-2009-6> (reporting on a call placed by Barney Frank to CEO of GM regarding the closure of a Massachusetts car parts warehouse). The facility was kept open. *See* George F. Will, *Barney Frank, Car Guy; And Green Guy. So He Pressures GM*, NEWSWEEK, June 22, 2009, available at <http://www.newsweek.com/id/201949>.

<sup>63</sup>*See, e.g.*, Joseph Greenspon's Sons Iron & Steel Co. v. Pecos Valley Gas Co., 156 A. 350, 352 (Del. Super. Ct. 1931) (stating corporate president's implied powers include "all acts of an ordinary nature which by usage or necessity are incidents to his office and by virtue of his office he may enter into a contract and bind his corporation.").

however, the analysis under section 102(b)(7) is different. Section 102(b)(7) shields only directors (or, rather, people acting in their capacity as directors) from monetary liability for breaches of their fiduciary duty.<sup>64</sup> Since section 102(b)(7) does not apply to fiduciary duty breaches by officers acting in their capacity as officers, it would present no barrier to a lawsuit.

Moreover, a CEO of a government-controlled company is clearly dependent on the goodwill of his controlling shareholder for his continued tenure. If the CEO caves to governmental pressure, it is at least plausible to assert that the CEO acted to preserve his own position as an executive, and not because he sincerely believed that he was serving the best interest of the corporation. As such, the CEO could be deemed not to have acted in good faith and section 102(b)(7), even if it were to apply, would not shield him from monetary liability.<sup>65</sup>

But while a suit against an officer would have an easier time surviving a challenge under section 102(b)(7), it raises additional complications as to whether demand would be excused. Conceptually, for a shareholder to bring a derivative lawsuit—and most of these lawsuits would be derivative law-suits<sup>66</sup>—that shareholder would first have to make a demand on the company's board to bring the lawsuit itself.<sup>67</sup> In practice, derivative plaintiffs in Delaware almost always claim that the demand is excused because it is futile.<sup>68</sup>

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<sup>64</sup>See DEL. CODE ANN. tit 8, § 102(b)(7) (2006) (specifying the "personal liability of a director").

<sup>65</sup>See *id.* (stating that director exculpation is not available for "acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law").

<sup>66</sup>Derivative lawsuits assert a claim on behalf of the corporation. The most straightforward way to determine whether a lawsuit is derivative is to inquire whether, if damages are payable, they would be paid to the corporation or to the shareholders directly. *Tooley v. Donaldson, Lufkin, & Jenrette, Inc.*, 845 A.2d 1031, 1033 (Del. 2004). Additionally, a lawsuit that claims that Company A extended a loan on preferential terms to Company B, which is controlled by the same shareholders, is a derivative lawsuit since Company A suffers the harm (it receives a below-market interest rate) and would receive any damages. See *id.* (identifying "who suffered the alleged harm (the corporation or the suing stockholders, individually)" as another method to distinguish direct from derivative lawsuits).

<sup>67</sup>DEL. CT. CH. R. 23.1; *Aronson v. Lewis*, 473 A.2d 805 (Del. 1984)

<sup>68</sup>See Geoffrey Miller, *Political Structure and Corporate Governance: Some Points of Contrast Between the United States and England*, 1998 COLUM. BUS. L. REV. 51, 65 (concluding that "derivative litigation in the United States nearly always proceeds under the allegation that demand would be 'futile' and therefore should be excused"); *cf.* *FLI Deep Marine LLC v. McKim*, No. 4138-VCN, 2009 WL 1204363, at \*3 (Del. Ch. Apr. 21, 2009) ("[W]here a shareholder instead chooses to make a demand upon the board of directors, she concedes the independence of a majority of the board . . . and is precluded from . . . arguing that demand should be excused because the directors are conflicted.").

While Delaware courts ordinarily apply the *Aronson* test to determine demand futility,<sup>69</sup> in some situations a standard announced by the Delaware Supreme Court in *Rales v. Blasband* applies.<sup>70</sup> The *Rales* standard effectively eliminates the second prong of the *Aronson* test and requires a derivative plaintiff to allege specific facts that create a reasonable doubt as to whether a majority of the board in office at the time demand would have been made was disinterested or independent.<sup>71</sup> *Rales* is relevant in a case in which the board, at the time of demand, did not consist of the same members as the board that approved the challenged transaction.<sup>72</sup> The rationale for the revised test is that, since the incumbent board had no role in approving the underlying transaction, it is in a position to determine whether a lawsuit should be brought even if the underlying transaction was not the product of the valid exercise of business judgment of a different board.<sup>73</sup>

The Delaware Supreme Court has identified three scenarios in which the *Rales* standard applies. The first scenario was the one at issue in *Rales*: the challenged decision had been made by the board of a different corporation.<sup>74</sup> The second involves a decision made by a board, the majority of whose members have since been replaced.<sup>75</sup> The third scenario, of interest here, is when the subject of the derivative suit is not a business decision of the board.<sup>76</sup> "The [Delaware] Supreme Court included the [third] scenario out of a concern that demand upon a board should not be excused when a board did not have the opportunity to consider [the] corporate action [at issue]."<sup>77</sup>

The third scenario seems to fit the case in which the CEO approves a transaction under pressure from a government controlling shareholder without seeking board approval. If *Rales* applies to this situation, for demand to be excused, a derivative plaintiff would have to raise doubts as to the disinterestedness and independence of a majority of the board. Inside directors are generally not regarded as independent of a controlling

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<sup>69</sup>See *supra* notes 23-26 and accompanying text.

<sup>70</sup>*Rales v. Blasband*, 634 A.2d 927, 933-35 (Del. 1993).

<sup>71</sup>*Id.* at 934.

<sup>72</sup>*Id.*

<sup>73</sup>See *id.* at 933 ("Where there is no conscious decision by directors to act or refrain from acting, the business judgment rule has no application." (citing *Aronson v. Lewis*, 473 A.2d 805, 813 (Del. 1984))).

<sup>74</sup>*Rales*, 634 A.2d at 934.

<sup>75</sup>*Id.*

<sup>76</sup>*Id.*

<sup>77</sup>*Ryan v. Gifford*, 918 A.2d 341, 353 n.29 (Del. Ch. 2007).

shareholder, but generally constitute far less than a majority of a board. Whether a derivative plaintiff could satisfy the *Rales* test would thus depend on whether the plaintiff could adduce sufficient facts to challenge the independence or disinterestedness of a sufficient number of outside directors, both directors selected by the Treasury and others.

Although our hypothetical seems to fit squarely in the last *Rales* scenario, it is not entirely clear that *Rales* actually applies in this context. The underlying rationale for applying *Rales* to officers' decisions that were not approved by the board is that the board, not having been involved in the business decision, is in a good position to determine whether a lawsuit should proceed. There is no indication that the court, in announcing the *Rales* standard, specifically focused on the application of the last *Rales* scenario to instances in which the underlying transaction would not be accorded business judgment protection even if approved by independent directors. But the application of *Rales* in that context would generate exactly the tension that we discussed before: independent directors, who would lack the power, by approving the transaction, to eliminate substantive judicial review (through changing the substantive standard to business judgment) would have the power to eliminate substantive review by refusing to bring a lawsuit after demand has been made. Moreover, if they would have this power only in instances in which the underlying transaction was *not* submitted to the board (since otherwise *Aronson* would apply, rather than *Rales*), this would generate perverse incentives for companies with controlling shareholders not to seek prior board approval for suspicious transactions, incentives that run counter to the process-oriented spirit of Delaware corporate law. For these reasons, we would regard the issue of whether *Rales* applies to such cases as unresolved.

### III. WHY DELAWARE SHOULD AVOID A FIGHT WITH WASHINGTON AND HOW IT SHOULD DO SO: A THEORY OF DUCKING

For some set of transactions, Delaware courts may be asked to look into transactions in which the government, as controlling shareholder, has a conflict of interest. But is this good news for Delaware? Should Delaware want the case? When the politics of automobile industry bailouts is combined with the politics of corporate law, we submit that Delaware will find itself in an impossible position. Historically, Delaware has generally avoided fights with Washington.<sup>78</sup> If presented with a situation resembling

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<sup>78</sup>See Kahan & Rock, *supra* note 10, at 714-15 (concluding "Delaware has so far been

our hypothetical, Delaware should want to continue that history. It can do so by "ducking" the case under Delaware Court of Chancery Rule 19.

A. *Is This a Case that Delaware Should Want?*

In light of our earlier discussion, let us assume that a claim attacking the conflicted transaction has been filed in the Delaware Court of Chancery and will not be removed or dismissed. Consider how it could play out and what it would mean for Delaware. The core, substantive question would be whether the Treasury improperly pressured DMAC to loan money to DM on preferential terms. If litigated in the Court of Chancery, we would enjoy the spectacle of senior Treasury officials being called to testify under oath in a deposition or trial regarding the Treasury's role in the transaction.<sup>79</sup> There would be fights over whether a sitting Secretary or Assistant Secretary of the Treasury could be forced to testify in a civil suit, whether his actions are protected by executive privilege, and so forth.

As controversial as these matters would be, imagine what would happen if a Delaware chancellor actually enjoined the loans from DMAC to DM or found that corporate directors or officers, acting in accordance with the Treasury directions, were subject to monetary liability. Congress would explode in outrage: One of the smallest states in the Union is daring to interfere with national economic policy! After all, Congressmen would argue, the taxpayers bailed out DMAC! As majority owners, surely they get to decide whether to do this or not! Senators would convene hearings: "we've got the right and responsibility to ask these questions."<sup>80</sup> Barney Frank would come after Delaware for obstructing federal policy. Imagine the threats from Congress and even the White House to displace Delaware if it dared to stand in the way of rescuing the automobile industry on behalf of "fat cats," "speculators" or even "locusts."<sup>81</sup>

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successful in fending off. . . potential threats" to its "dominant position in corporate law"); Marcel Kahan & Edward B. Rock, *Symbiotic Federalism and the Structure of Corporate Law*, 58 VAND. L. REV. 1573, 1617 (2005) (stating that Delaware "eschews controversy" and prefers to address reform through its courts rather than legislation or public hearings).

<sup>79</sup>To get a sense of the politics of the controversy over the approval of the SEC's settlement with Bank of America regarding the SEC's disclosure claims arising out of the merger with Merrill Lynch, see generally Kara Scannell et al., *Judge Tosses Out Bonus Deal—SEC Pact with BofA over Merrill Is Slammed; New York Weighs Charges Against Lewis*, WALL ST. J., Sept. 15, 2009, at A1. See also SEC v. Bank of Am. Corp., 653 F. Supp. 2d 507, 508 (S.D.N.Y. 2009) (Rakoff, J.) (rejecting a proposed consent judgment).

<sup>80</sup>Whoriskey & Marr, *supra* note 7 (quoting Sen. Mark Warner).

<sup>81</sup>See Derrick Henry, *Obama Decries 'Fat Cat Bankers,'* N.Y. TIMES, Dec. 14, 2009, <http://thecaucus.blogs.nytimes.com/2009/12/14/obama-decries-fat-cat-bankers/> (quoting President Obama: "'I did not run for office to be helping out a bunch of fat cat bankers on Wall Street'"); Jim

In thinking about Delaware's place in the corporate law landscape, it is always worth remembering that Congress has sufficient power under the Commerce Clause to nationalize corporate law.<sup>82</sup> It could decide tomorrow to create a federal incorporation regime that would preempt state corporate law, thereby putting Delaware out of business. In many respects, the federal government is not only the controlling shareholder of DMAC, with the power to retaliate, but also has potential control over, and the power to retaliate against, Delaware corporate law.

Delaware, of course, derives substantial profits from being the domicile of choice for publicly traded corporations.<sup>83</sup> Naturally, Delaware decision makers would not want to endanger the continued flow of these profits to Delaware residents and the Delaware fisc. As we have discussed elsewhere, Delaware has developed a refined strategy of staying out of the political limelight.<sup>84</sup> Although there will always be people attacking Delaware's position as illegitimate,<sup>85</sup> such criticism does not gain political traction so long as Delaware does not antagonize important organized interests.

From that perspective, taking a stand on controversial and partisan issues—such as whether, in a specific case, it is legitimate for the federal government to induce government-controlled companies to take actions considered by the federal government to be economically beneficial, even if they do not benefit the minority shareholders in the government-controlled company—is about the last thing that Delaware would want to do. This class of cases thus calls for a different strategy which Delaware has sometimes employed in the past:<sup>86</sup> the strategy of ducking.

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Rutenberg & Bill Vlasic, *Chrysler Files for Bankruptcy Protection; U.A.W. and Fiat to Take Control*, N.Y. TIMES, May 1, 2009, at A1 (stating that President Obama refers to objecting bondholders as "speculators"); Ashley Seager, *Germany Pledges Code to Curb Hedge Fund "Locusts,"* GUARDIAN (London), May 19, 2007, at 41 (stating that German regulators refer to hedge funds as "locusts").

<sup>82</sup>See Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV. 588, 598 (2003) ("If Congress wishes, it can swoop in and take over any major aspect of corporate law, as it often has, and more often has threatened."); Kahan & Rock, *supra* note 78, at 1585-86.

<sup>83</sup>See Marcel Kahan & Ehud Kamar, *The Myth of State Competition in Corporate Law*, 55 STAN. L. REV. 679, 724 (2002) (describing and quantifying Delaware's benefits).

<sup>84</sup>See Kahan & Rock, *supra* note 78, at 1617-18.

<sup>85</sup>See, e.g., Jonathan Chait, *Rogue State*, NEW REPUBLIC, Aug. 19, 2002, at 20, 23 (stating that "Delaware's loose rules amount to an invitation to engage in chicanery").

<sup>86</sup>See Kahan & Rock, *supra* note 78, at 1621 (suggesting that Delaware tends to duck "hot potato" issues such as executive compensation because they are prone to trigger "populist anger").

### B. *A Theory of Ducking*

Assuming for now that this is one of those rare situations in which Delaware should duck, how should it do so? To start, what makes a good ducking strategy?

First, Delaware should only duck when it is *necessary* to do so, when important Delaware interests are at stake. If it ducks unnecessarily, it risks losing its central position in corporate law.

Second, Delaware should only duck when doing so would be *effective* in avoiding a no-win situation. Otherwise, it is pointless. Moreover, it should only choose instances in which ducking is *politically defensible*.

Third, if Delaware ducks, it should do so with regard to issues that are *peripheral* to Delaware's position in corporate law or which *minimally* distort settled doctrine. Thus, preferably, it should find a *procedural* rather than a substantive rationale for ducking. Furthermore, in ducking, it should strive for a *facially neutral* principle so as not to call unnecessary attention to itself.

Finally, because of its obligations to the parties, it should try to duck only when the parties have a plausibly adequate, or superior, *alternative forum* in which their claims can be adjudicated.

The Delaware Court of Chancery's decision in *In re Bear Stearns Cos. Shareholder Litigation*<sup>87</sup> provides an excellent example of an appropriate and successful duck.<sup>88</sup> In order to ensure that its emergency merger with J.P. Morgan Chase would be approved by its reluctant shareholders, Bear Stearns issued just under 40% of its shares to J.P. Morgan Chase in a share ex-change, with no limit on additional market purchases, thereby rendering the shareholder vote a *fait accompli*.<sup>89</sup> As we have argued elsewhere, this case raised difficult and fundamental issues under Delaware law, issues that had broad implication for shareholders' statutory right to veto mergers and the fiduciary duties of boards not to undermine this right.<sup>90</sup> On the other hand, the Bear Stearns–J.P. Morgan Chase merger had been pressed by the Fed and the Treasury as necessary to prevent the collapse of the international financial system.<sup>91</sup>

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<sup>87</sup>No. 3643-VCP, 2008 WL 959992 (Del. Ch. Apr. 9, 2008), *reprinted in* 33 DEL. J. CORP. L. 515 (2008).

<sup>88</sup>Kahan & Rock, *supra* note 10, at 715.

<sup>89</sup>*In re Bear Stearns*, 2008 WL 959992, at \*3, *reprinted in* 33 DEL. J. CORP. L. at 519.

<sup>90</sup>Kahan & Rock, *supra* note 10, at 744.

<sup>91</sup>*See In re Bear Stearns*, 2008 WL 959992, at \*2, *reprinted in* 33 DEL. J. CORP. L. at 517 ("To preserve the stability and orderliness of the financial markets, the Federal Reserve acted promptly to resolve the Bear Stearns situation.").

Contemporaneous actions challenging the stock swap were filed in the Delaware Court of Chancery and New York Supreme Court.<sup>92</sup> Vice Chan-celloer Parsons, on motion by the defendants, stayed the Delaware action in favor of the New York action.<sup>93</sup> This stay was necessary because Delaware was caught on the horns of a dilemma: it would be politically dangerous for Delaware to confront the New York Federal Reserve Bank and the U. S. Department of Treasury on a matter with implications for the stability of the financial system; but upholding the share exchange posed hard questions of Delaware takeover law.

The stay in favor of the New York case was *effective* in that it allowed Delaware to avoid potential conflict with the Fed and *politically defensible* in that the stated basis was comity towards a sister state court, a legitimate and important consideration in a federal system. Though the underlying sub-stantive issue was important for Delaware, the rationale for the ducking was based on malleable principles of comity jurisprudence, which are both peripheral to Delaware's corporate law and unlikely to generate a precedent that future Delaware courts will feel bound to follow. The decision was also *minimal* insofar as it avoided the conflict without reworking or unsettling Delaware substantive mergers and acquisitions law.

Moreover, the stay was *facially neutral* in that it did not favor plaintiffs or defendants on the merits. Finally, plaintiffs had a plausibly *adequate alternative forum*; the New York Supreme Court had all the parties in front of it and could adjudicate all claims.<sup>94</sup>

How might Delaware duck a confrontation with the federal government in our hypothetical suit against DMAC's directors? There are some bad alternatives. It could, for example, hold the transaction entirely fair even if it was not. It could refuse to evaluate the entire fairness of the transaction based on some generally applicable rule, such as a general holding that, if no individual director has violated his fiduciary duties, self-dealing transactions with controlling shareholders enjoy the protection of the business judgment rule, or that demand is not excused in these kinds of cases. It could exploit judicial discretion in the granting of equitable relief in a way that ignored the realities of the matter by, for example, refusing to grant an injunction because there was no irreparable harm or because the risk of harm from enjoining the loan outweighed the risk to plaintiff of not enjoining.

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<sup>92</sup>*Id.* at \*3, reprinted in 33 DEL. J. CORP. L. at 519.

<sup>93</sup>*Id.* at \*8, reprinted in 33 DEL. J. CORP. L. at 527.

<sup>94</sup>See *id.* at \*4, reprinted in 33 DEL. J. CORP. L. at 520 (stating that "[t]he Delaware Action closely parallels the New York Action").

If, in fact, the loan is not entirely fair, these solutions are clearly problematic. Is there a better way out?

*C. Ducking Under Delaware Court of Chancery Rule 19*

Delaware Court of Chancery Rule 19 ("Joinder of Persons Needed for Just Adjudication") provides the optimal basis for ducking the issues posed by the hypothetical. Delaware's Rule 19 tracks the comparable Federal Rule of Civil Procedure:

Rule 19. Joinder of persons needed for just adjudication.

(a) Persons to be joined if feasible. A person who is subject to service of process and whose joinder will not deprive the Court of jurisdiction over the subject matter of the action shall be joined as a party in the action if (1) in the person's absence complete relief cannot be accorded among those already parties, or (2) the person claims an interest relating to the subject of the action and is so situated that the disposition of the action in the person's absence may (i) as a practical matter impair or impede the person's ability to protect that interest or (ii) leave any of the persons already parties subject to a substantial risk of incurring double, multiple, or otherwise inconsistent obligations by reason of the claimed interest. If the person has not been so joined, the Court shall order that the person be made a party. If the person should join as a plaintiff but refuses to do so, the person may be made a defendant, or in a proper case, an involuntary plaintiff. If the joined party objects to venue and joinder of that party would render the venue of the action improper, that party shall be dismissed from the action.

(b) Determination by Court whenever joinder not feasible. If a person as described in paragraph (a)(1) and (2) hereof cannot be made a party, the Court shall determine whether in equity and good conscience the action should proceed among the parties before it, or should be dismissed, the absent person being thus regarded as indispensable. The factors to be considered by the Court include: First, to what extent a judgment rendered in the person's absence might be prejudicial to the person or those already parties; second, the extent to which, by protective provisions in the judgment, by the

shaping of relief, or other measures, the prejudice can be lessened or avoided; third, whether a judgment rendered in the person's absence will be adequate; fourth, whether the plaintiff will have an adequate remedy if the action is dismissed for nonjoinder.

(c) Pleading reasons for nonjoinder. A pleading asserting a claim for relief shall state the names, if known to the pleader, of any persons as described in paragraph (a)(1) and (2) hereof who are not joined, and the reasons why they are not joined.

(d) Exception of class actions. This rule is subject to the provisions of Rule 23.<sup>95</sup>

Notwithstanding the confusing phrasing and structure of the rule, it provides a fairly straightforward three-step analytic structure.<sup>96</sup> First, is the absentee needed for just adjudication? A party is "required/necessary" if, as the rule states,

(1) in the person's absence complete relief cannot be accorded among those already parties, or (2) the person claims an interest relating to the subject of the action and is so situated that the disposition of the action in the person's absence may (i) as a practical matter impair or impede the person's ability to protect that interest or (ii) leave any of the persons already parties subject to a substantial risk of incurring double, multiple, or otherwise inconsistent obligations by reason of the claimed interest.<sup>97</sup>

Second, is joinder of the necessary absentee feasible? If yes, then the person must be joined. If, on the other hand, joinder is not feasible, then the analysis proceeds to the third step—whether the case should proceed or be

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<sup>95</sup>DEL. CT. CH. R. 19.

<sup>96</sup>See generally 4 RICHARD D. FREER, MOORE'S FEDERAL PRACTICE ch. 19 (3d ed. 1997) (interpreting the very similar FED. R. CIV. P. 19). Federal court interpretation of parallel court rules is given "great weight" by Delaware courts. See, e.g., Nat'l Educ. Corp. v. Bell & Howell Co., No. 7278, 1983 WL 8946, at \*2 (Del. Ch. Dec. 13, 1983), reprinted in 8 DEL. J. CORP. L. 610, 614 (1983) (citing *Canaday v. Super. Ct. in and for New Castle County*, 119 A.2d 347 (Del. 1955)).

<sup>97</sup>DEL. CT. CH. R. 19(a).

dismissed. In other words, should the absentee be regarded as "indispensable?"

Consider, then, how this applies to the question of whether the Treasury is an "indispensable" party in our hypothetical lawsuit against the directors. In the first step, one could argue that, as the dominant force apply-ing pressure to proceed with the transaction, the Treasury is a "required" or "necessary" party. Clearly, the Treasury, as a controlling shareholder, would be principally liable for any damages awarded to the corporation. As such, it is unclear whether, in the absence of the Treasury, complete damage relief could be awarded. Moreover, if the suit is for injunctive relief, the grant of an injunction would, as a practical matter, impair or impede the Treasury's ability to protect its interest.

Second, is joinder feasible? In our hypothetical, the answer is clearly a negative. As discussed above, there is exclusive federal jurisdiction under 28 U.S.C. § 1346 and any case would be immediately removed under 28 U.S.C. § 1442.

We thus come to the third and critical step, namely, since joinder of the Treasury is not feasible, should the case proceed or be dismissed? Under the rule, there are four factors. "First, to what extent [might] a judgment rendered in the person's absence . . . be prejudicial to the person or those already parties[?]"<sup>98</sup> Under Delaware case law, "[i]t is not necessary to join a person whose interests are fully protected by the parties already present in the case."<sup>99</sup> But in our hypothetical, the Treasury and the DMAC directors who face a claim for damages have conflicting interests, especially if the di-rectors' defense is that "the controlling shareholder made me do it." In such circumstances, not only will the directors not represent the Treasury's inter-ests, it is also hard to see how they can adequately represent their own inter-ests in the Treasury's absence.

The second factor is "the extent to which, by protective provisions in the judgment, by the shaping of relief, or other measures, the prejudice can be lessened or avoided."<sup>100</sup> *Joyce v. Cuccia* provides an example of a situation in which an absentee's claimed rights to ownership of stock can be protected in crafting judgment.<sup>101</sup> In that case, the court refused to find the absent party who claimed ownership of half of a block of stock to be an in-

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<sup>98</sup>*Id.* R. 19(b).

<sup>99</sup>*Moran v. Household Int'l, Inc.*, 490 A.2d 1059, 1073 (Del. Ch.), *aff'd*, 500 A.2d 1346 (Del. 1985).

<sup>100</sup>DEL. CT. CH. R. 19(b).

<sup>101</sup>*Joyce v. Cuccia*, No. Civ. A. 14,953, 1997 WL 257448, at \*9-10 (Del. Ch. May 14, 1997), *reprinted in* 23 DEL. J. CORP. L. 834, 853-55 (1998).

dispensable party because "any decree granting specific performance [could] be made subject to [the absent party's] entitlement to the stock as determined by [court order]."<sup>102</sup> By contrast, one can plausibly argue that the hypo-thetical presents a unitary issue—is the transaction entirely fair?—and that there is no way to shape the relief to lessen or avoid prejudice.

The third factor is "whether a judgment rendered in the person's absence will be adequate."<sup>103</sup> This factor points against holding the Treasury to be an indispensable party; the transaction could be enjoined and monetary liability imposed on the directors, if appropriate, in the absence of the Treasury.

The fourth factor is "whether the plaintiff will have an adequate remedy if the action is dismissed for nonjoinder."<sup>104</sup> This raises the question whether complete relief would be available in federal court. As with all the legal issues raised by government control, this is a complicated issue that does not have a clear answer. The issue is whether fiduciary duty claims against directors would be within the federal court's "supplemental jurisdiction" ("pendent party jurisdiction") under 28 U.S.C. § 1367. Although § 1367 codified "pendent party jurisdiction," it only did so for actions in federal district court. If, as discussed above, a breach of fiduciary duty is a tort claim for purposes of the FTCA, all claims could be brought in federal district court and § 1367 would provide for pendent party jurisdiction over the directors, permitting complete relief. On the other hand, if a breach of fiduciary duty is not a tort but, instead, a claim for "unliquidated damages in cases not sounding in tort," the case would fall under the Tucker Act and would have to be brought in the Court of Federal Claims. In that event, the pre-§ 1367 principles would determine whether there was pendent party jurisdiction (there are no Court of Federal Claims cases on point).

As this analysis of Delaware Court of Chancery Rule 19 suggests, there is sufficient flexibility within the rule, and sufficient factual basis, for a court to hold the Treasury to be an "indispensable party." Would it be advisable to do so? Would it be another exemplary duck?

Consider the factors identified above in our theory of ducking. As noted earlier, avoiding a confrontation with the Treasury and Congress is important for Delaware as such a confrontation could endanger Delaware's historic and distinctive role in corporate law and the economic benefits Delaware obtains from maintaining this role.

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<sup>102</sup>*Id.* at \*10, reprinted in 23 DEL. J. CORP. L. at 855.

<sup>103</sup>DEL. CT. CH. R. 19(b).

<sup>104</sup>*Id.*

Second, a dismissal under Rule 19 would be *effective* in allowing Delaware to avoid a conflict. It would leave the substantive decision to the federal judiciary, a body more insulated against political attacks and with greater legitimacy in rendering decisions of national importance. Even though the federal judiciary would apply Delaware corporate law in rendering its decision on the conduct of the officers and directors, the underlying fundamental principles—that controlling shareholders may not engage in unfair transactions—are uncontroversial. The controversial issues—how should these principles be applied, should they be modified when the controlling shareholder is the federal government and purports to pursue national interest, and was a specific transaction really unfair?—would be determined by federal judges based on the specific facts of a case and without much guidance from Delaware precedents. Because both federal and Delaware interests support Delaware's abstention, the decision would be *politically defensible*.

Third, a dismissal would have minimal impact on settled doctrine. Because Rule 19 is *procedural*, a dismissal would avoid any changes to substantive Delaware corporate law. To the contrary, not rendering a substantive decision in these cases would avoid potential distortions that could result if Delaware tried to squeeze self-dealing transactions with a governmental controlling shareholder into its general jurisprudence of controlling shareholder fiduciary duties. Moreover, holding the Treasury to be an indispensable party would be *facially neutral* inasmuch as it is based on a plausible interpretation of a long-standing and generally applicable procedural rule.

Finally, the parties would have a plausibly adequate *alternative forum* in which all issues could be resolved in a single proceeding, at least if there is pendent party jurisdiction.

Delaware's central role in corporate law depends on Delaware courts deciding most important questions that arise under its corporate law. But a variety of circumstances arise that counsel in favor of not acting. Sometimes, considerations of comity lead Delaware to defer to other states. Federal control of a Delaware corporation, we suggest, is another context in which discretion is the better part of valor.

#### IV. CONCLUSION

In the last two years, the United States has faced a historic collapse of its financial markets and its banking sector. In response, the federal government has embarked on unprecedented initiatives. Along the way, it has ended up with control of some major publicly traded Delaware corporations. Amongst the numerous financial, political, and legal challenges raised by

these initiatives is the effect of government control on Delaware's jurisprudence of controlling shareholders.

It remains to be seen how long this exceptional period will last. If the Treasury exits from these positions quickly, we may never have to resolve the legal issues raised by government ownership. If the Treasury holds these positions for the long term, a new, federal legal structure will have to be de-veloped, probably involving federal incorporation for the controlled firms.

In the meantime, Delaware should keep its head down. It has nothing to gain, and much to lose, from a confrontation with the Treasury, the Federal Reserve, and Congress. So long as it can avoid such conflicts without doing substantial damage to its law or its place in the corporate land-scape, it would be well advised to do so.