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Fiduciary duties of directors and officers to the corporation and its shareholders in the United States

1. Introduction

The issue of the liability of the board of directors is crucial from a practical point of view – decisions of the board of directors affect not only the corporation and its shareholders but also creditors and investors of the company. The American legal system, in particular the legal system of the State of Delaware, provides a comparatively much more hospitable environment for directors than the continental systems. Delaware law encourages directors to take greater risk in their business decisions by not subjecting those, as these decisions to evaluations by courts as long as 1) they meet all the procedural criteria and 2) they did not involve a breach of duty of loyalty to the corporation. This deferential approach, however, creates the collateral risk of abuse of powers that could result in significant injury to the shareholders, the bankruptcy of the corporation, and ultimately the destabilization of the economy. In the United States, the imposition of fiduciary duties of directors and officers provides a critical way for shareholders to enforce a degree of control over those directors and officers who abuse their powers. As the American legal system is based on many separate legal regulations caused by the federal system, the model act will be emphasized, because it is a basis, that many states use for adopting their own statutes.

Corporate governance[1] is the broad term used to describe the relationships between board of directors, officers and shareholders.[2] In the United States, corporate governance issues have been evolving, especially after the collapse of the Enron Corporation in the late 1990's. Subsequently, the *Sarbanes-Oxley Act*[3] entered into force and New York Stock Exchange (NYSE) reviewed its requirements with regard to the board of directors.[4] Control mechanisms became more sophisticated, and the role of the board of directors in corporate governance was carefully examined.[5] As a result, the NYSE requires that all listed corporations have a majority of independent directors and it enumerates relationships which may impede independence.[6]

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[1] F. Barca, *Some views on U.S. corporate governance*, „Columbia Business Law Review", 1/1998, p. 5.

[2] R.W. Hamilton, *Corporate governance in America 1950-2000: major changes but uncertain benefits*, „Journal of Corporate Law", 25/2000, p. 350.

[3] Sarbanes-Oxley Act of 2002, Pub. L. No. 107–204, 116 Stat. 745 (2002).

[4] J.E. Fisch, *Leave it to Delaware: why Congress should stay out of corporate governance*?, „Delaware Journal of Corporate Law", 37/2013, p. 733–734.

[5] C.G. Bishop, *Directorial Abdication and the Taxonomic Role of Good Faith in Delaware Corporate Law*, „Michigan State Law Review", 2007, p. 910.

[6] M.I. Steinberg, M.D. Bivona, *Disney goes Goofy: agency, delegation and corporate governance*, „Hastings Law Journal", 60/2008, p. 227–228.

The continued development of corporate governance, especially fiduciary standards, provides the necessary control over the possible economic destabilization. The article focuses on the current state of fiduciary duties imposed on both directors and officers of American corporations and means for the shareholders to litigate when a breach of fiduciary duties arises.

This analysis begins with a brief description of the role of directors and officers in the modern corporation. The model of governance in the American corporation is similar to the single-tier system in the *Societas Europae*[7] ("European Company"), which provides an administrative board as opposed to the two-tier system of the company, which consists of a management board and a supervisory board. Then the article covers specific fiduciary duties and explains the differences between standards of reviews and standards of conduct, which are being used by courts to determine whether an individual is in breach of fiduciary duties. The differences between the criteria used by courts can be very subtle. The structure applied by the American legal system could provide guidance to the future legislative proposals with regard to not only the European Company, but also to corporations within the European Union.

2. Directors and officers

Directors represent shareholders within the structure of the corporation.[8] According to the *Model Business Corporation Act*[9] (MBCA) and the *Delaware General Corporation Law*[10] (DGCL), all corporate powers shall be exercised by or under the authority of, and the business and affairs of the corporation managed by or under the direction of, its board of directors (MBCA § 8.01, DGCL § 141.a). Every publicly-held corporation must have a board of directors, whereas shareholders in a closely-held corporation may enter into an agreement which eliminates the board of directors or restricts the discretion or powers of the board (MBCA § 7.32, DGCL § 351). A board of directors must consist of one or more individuals, with the number specified in or fixed in accordance with the articles of incorporation or bylaws. Furthermore, directors are elected at the first annual shareholders' meeting and at each annual meeting thereafter, unless their terms are staggered (MBCA § 8.03, DGCL § 141). It is worth mentioning that vacancies on the board of directors may occur as a result of resignation, death or removal of a director.[11] Furthermore, shareholders may remove one or more directors with or without cause, unless the articles of incorporation provide that directors may be removed only for cause (MBCA § 8.08, DGCL § 141).

In general, all actions of the board have to be taken at duly called regular or special meetings (MBCA § 8.20, DGCL § 141). Statutes allow directors to be remotely present.

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7 Council Regulation (EC) No 2157/2001 of 8 October 2001 on the Statute for a European Company and Council Directive 2001/86/EC of 8 October 2001 supplementing the Statute for a European company with regard to the involvement of employees [Official Journal L 294, 10.11.2001].

8 D. G. Smith, C. A. Williams, *Business Organizations. Cases, Problems and Case Studies*, New York 2012, p. 174.

9 ABA Section of Business Law, *Model Business Corporation Act Ann.* (4th ed. 2013).

10 *Delaware General Corporation Law*, *Del. Code Ann.* tit. 8, § 10 (2011).

11 D. G. Smith, C. A. Williams, *Business Organizations*…, *op. cit.*, p. 200.

Actions by the board of directors might be, however, taken without a meeting, if each director signs a consent describing the discussed action and delivers it to the corporation, unless the articles of incorporation or bylaws require otherwise (MBCA § 8.21, DGCL § 141).

On the other hand, officers, such as Chief Executive Officer, Chief Financial Officer, President, Chief Operation Officer, etc., are in charge of day-to-day operations of the corporation.[12] A corporation has the officers described in its bylaws or appointed by the board of directors in accordance with the bylaws. Officers are agents of either the shareholders or the corporations, whereas directors are not.[13] The same individual may simultaneously hold more than one office in a corporation (MBCA § 8.41, DGCL § 142). Each officer has the authority and shall perform the duties set forth in the bylaws or, to the extent consistent with the bylaws, the duties prescribed by the board of directors or by direction of an officer authorized by the board of directors to prescribe the duties of other officers (MBCA § 8.41, DGCL § 142). Typically, the officers are responsible for running the business, but their authority stems from the directors.[14]

3. Fiduciary duties

In general, fiduciary duties were developed as common-law principles,[15] but recently they have been included in the statutes (MBCA § 8.30). The DGCL, however, still does not contain any provision on director's fiduciary duties because in Delaware such duties are subject to judge-made rules.[16] It has to be emphasized that cases arising under the MBCA often cite major Delaware cases as precedents, thus Delaware cases shall be discussed in this analysis.[17]

A fiduciary relationship is based on the premise that the fiduciary works in a trustworthy manner for the beneficiary in accordance with the best interest of the latter.[18] Shareholders are presumed to be entrustors and beneficiaries, while the managers (directors and officers) are the fiduciaries.[19] Although the courts regularly state that fiduciary duties are owed to both shareholders and the corporation, it has to be remembered that shareholders and corporations might have divergent interests.[20] Both directors and officers owe fiduciary duties to the corporation (duty of care, duty of loyalty, duty of obedience, and duty of good faith).[21] As a result, fiduciary duties are limitations to the discretion of directors and officers

[12] *Ibidem*, p. 174.

[13] L.P.Q. Johnson, D. Millon, *Recalling why Corporate Officers are Fiduciaries*, „William & Mary Law Review", 2005, p. 1607.

[14] M.W. Shaner, *The (Un)Enforcement of Corporate Officers' Duties*, „U.C. Davis Law Review", 2014, p. 285–286.

[15] D.G. Smith, C.A. Williams, *Business Organizations…*, *op. cit.*, p. 47.

[16] *Ibidem*, p. 362.

[17] *Ibidem*.

[18] K.A. Alces, *Debunking the Corporate Fiduciary Myth*, „Journal of Corporation Law", 35/2009, p. 246.

[19] J. Velasco, *Fiduciary Duties and Fiduciary Outs*, „George Mason Law Review", 2013, p. 165.

[20] A.S. Gold, *Dynamic Fiduciary Duties*, „Cardozo Law Review", 34/2012, p. 494.

[21] F.H. O'Neal, R.B. Thompson, *Close Corp and LLCs: Law and Practice*, § 9.47 *Fiduciary duty, including enhanced fiduciary duties in LLCs*, 2014.

with regard to the management of the corporations' affairs.[22] Furthermore, the existence of fiduciary duties creates a balance of power inside the structure of the corporation.[23]

Fiduciary duties stem from the agency relationship.[24] Thus, they apply to all entities, including partnerships, limited liability companies, and corporations. Fiduciary duties are based on trust.[25] In *Meinhard v. Salmon*, the New York Court of Appeals stated that joint adventurers, like copartners, owe to one another the duty of the finest loyalty ("the punctilio of an honor the most sensitive is the standard of behavior").[26]

For years there has been a debate whether and to what extent officers owe fiduciary duties to a corporation and its shareholders. In *Gantler v. Stephens* the Delaware Supreme Court settled the dispute by stating: "officers of Delaware corporations, like directors, owe fiduciary duties of care and loyalty, and the fiduciary duties of officers are the same as those of directors".[27] Nevertheless, there is still little development in this area.[28] It has to be remembered that even though directors are not agents, they are fiduciaries for the corporation and its shareholders.[29] The primary obligations are duties of care and loyalty, which are being analyzed below.

It is of utmost importance that breaching fiduciary duties does not automatically lead to liability for a director because corporate law is based on the distinction between standards of conduct and standards of review.[30] The two terms are in a strict correlation with each other.[31] A standard of conduct is a norm, which establishes the obligations of directors and officers and is measured by fiduciary duties.[32] The standard of review is the test applied by courts to determine whether managers complied with the standard of conduct and whether liability could be imposed.[33] It is also a baseline to determine the burden of proof and pleadings.[34] The standards of review applied to the disputes regarding fiduciary duties are the Business Judgment Rule, which is a default standard of review,[35] and Entire Fairness, which will be discussed below.

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[22] J. Velasco, *Fiduciary Duties and…*, *op. cit.*, p. 165.

[23] F.H. O'Neal, R.B. Thompson, *Close Corp*, *op. cit.*

[24] D.G. Smith, C.A. Williams, *Business Organizations…*, *op. cit.*, p. 7.

[25] J.R. Trost, R.G. Schwartz, *Fiduciary Duties of Directors in the Chapter 11 and Insolvency Contexts*, 2000, p. 269.

[26] *Meinhard v. Salmon*, 249 N.Y. 458, 164 N.E. 545, Court of Appeals of New York, December 31, 1928.

[27] *Gantler v. Stephens*, 965 A.2d 695, Supreme Court of Delaware, January 27, 2009.

[28] M.W. Shaner, *The (Un)Enforcement of Corporate…*, *op. cit.*, p. 111.

[29] L.P. Q. Johnson, D. Millon, *Recalling why Corporate…*, *op. cit.*, p. 1607.

[30] J. Velasco, *Fiduciary Duties and…*, *op. cit.*, p. 165.

[31] W.T. Allen, J.B. Jacobs, L.E. Strine Jr, *Function over Form: a Reassessment of Standards of Review in Delaware Corporation Law*, „Delaware Journal of Corporate Law" 2001, p. 869.

[32] B.A. Olson, *Publicly Traded Corporations: Governance & Regulation*, § 3.1 *Overview of Delaware's standards of conduct/review*, 2014.

[33] M.A. Eisenberg, *The Divergence of Standards of Conduct and Standards of Review in Corporate Law*, „Fordham Law Review", 1993, p. 438.

[34] B.A. Olson, *Publicly Traded Corporations*, *op. cit.*

[35] *Ibidem*.

3.1. Duty of care

The duty of care is measured by the standard of an ordinarily prudent person (*Graham v. Allis-Chalmers*[36]), which means that the fiduciary must discharge her duties with the care that a person in like position would reasonably believe under the circumstances.[37] As provided by the statutes based on the Model Act, each member of the board of directors, when discharging the duties of a director, shall act in good faith and in a manner the director reasonably believes to be in the best interests of the corporation (MBCA § 8.30). One can breach a duty of care by gross negligence and not performing the duties in a well-informed manner, which was established in *Smith v. Van Gorkom*.[38] One may also breach a duty of care by utterly failing to perform duties (*Francis*[39]) or by making an egregious decision, measured by the waste standard (*Brehm v. Eisner*[40]).

Under the plaintiff's duty of care allegations, courts apply the abovementioned Business Judgment Rule (BJR). The BJR is a judicially-created rule, based on the presumption that directors who made a business decision acted in good faith, in an informed manner and in the best interest of a corporation (*Aronson v. Lewis*).[41] Since the BJR is a presumption, the burden of proof is placed on the plaintiff – the shareholders.[42] The BJR could only be overcome by showing gross negligence, lack of appropriate information, or by breaching the duty of loyalty (the standard of review will switch to the entire fairness[43]). The court would not second-guess the merits of the decision; instead, it would analyze only the procedural aspect of the decision (*Gagliardi v. Trifoods International, Inc.*,[44] *Shlensky v. Wrigley*[45]). In *Shlensky v. Wrigley*, for example, the Appellate Court of Illinois concluded that unless conduct of corporate directors borders on fraud, illegality or conflict of interest, no stockholder's derivative suit will lie.[46] The court here refers to the procedural mechanism allowing shareholders to seek damages from the breaching party, namely the derivative suit, which will be discussed later. The practical aspect of the BJR should be emphasized. It provides a tremendous amount of discretion with respect to the management of business of the corporation.[47] However, it is only available to directors or officers who neither appear on both sides of the transaction nor gain an improper financial benefit from the corporation.[48]

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[36] *Graham v. Allis-Chalmers Manufacturing Company*, 188 A.2d 125, „Supreme Court of Delaware", January 24, 1963.

[37] *Smith v. Van Gorkom*, 488 A.2d 858, Supreme Court of Delaware, January 29, 1985.

[38] *Ibidem*.

[39] *Frncis v. United Jersey Bank*, 432 A.2d 814, Supreme Court of New Jersey, July 1, 1981.

[40] *Brehm v. Eisner*, 746 A.2d 244, 249, Supreme Court of Delaware, February 9, 2000.

[41] *Aronson v. Lewis*, 473 A.2d 805, Supreme Court of Delaware, March 1, 1984.

[42] *Smith v. Van Gorkom*, *op. cit.*

[43] *Weinberger v. UOP*, Inc., 457 A.2d 701, 711, Supreme Court of Delaware, February 1, 1983.

[44] *Gagliardi v. Trifoods International, Inc.*, 683 A.2d 1049, Court of Chancery of Delaware, July 19, 1996.

[45] *Shlensky v. Wrigley*, 237 N.E.2d 776, Appellate Court of Illinois, April 25, 1986.

[46] *Ibidem*.

[47] A.S. Gold, *Dynamic Fiduciary Duties*, *op. cit.*, p. 500.

[48] C.G. Bishop, *Directorial Abdication and the Taxonomic Role of Good Faith in Delaware Corporate Law*, „Michigan State Law Review", 2007, p. 918.

Several pragmatic and policy reasons underlie the BJR. Being held in breach of a fiduciary duty may cause exorbitant monetary damages, which would have to be paid out of pocket of the decision maker. It might lead to an impairment of the business judgment of a director or an officer, who would be hesitant and reluctant in their decision-making process, which could lead to the corporation being less profitable. For these reasons, a corporation may provide an exculpation clause in its charter, which would limit or eliminate the liability for money damage in connection with the breach of the duty of care. Under the MBCA, liability could be eliminated or limited, except for the amount of unjustifiably received financial benefit, intentional infliction of harm, violation of criminal law and unlawful distribution (MBCA § 2.02.b.4). On the other hand, under the DGCL statute, a charter cannot eliminate the liability for the breach of the duty of loyalty, intentional infliction of misconduct or intentional violation of law, unlawful distribution, and improper personal benefit (DGCL § 102.b.7). As a result, with regard to the duty of care, exculpatory clause could work as a shield against the "well-informed manner" criterion.

3.2. Duty of loyalty

A breach of the duty of loyalty exists when the director stands on both sides of the transaction at issue or otherwise receives a personal benefit and is strictly related to the conflict of interest.[49] The typical fact patterns for breach of the duty of loyalty are:

1) usurpation of corporate opportunity;
2) competing with the corporation by officers of directors;
3) self-dealing;
4) systematic or sustained lack of oversight (used to be a breach of the duty of care);
5) dealings by a parent corporation with a subsidiary;
6) unequal treatment by a majority shareholder of minority shareholders in corporate acquisitions and reorganization transactions.[50]

In order to determine, whether there was a breach of the duty of loyalty, one must answer the following questions:

1) Did the decision maker disclose all the material information?
2) Was there approval of disinterested shareholders or directors?
3) Who bears the burden of proof? The plaintiff or the defendant?
4) Was the transaction fair to the company?[51]

Only after answering abovementioned questions would the court be able to determine if the director or officer could be held liable.

Another important question is whether the tainted transaction is void or voidable. A void transaction cannot be sanitized by approval, but voidable transactions can be cured by shareholder approval (*Michelson v. Duncan*[52]). Transactions are voidable in two types

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[49] D.G. Smith, C.A. Williams, *Business Organizations*, *op. cit.*, p. 401.

[50] R.F. Balotti, J.A. Finkelstein, *Delaware Law of Corporations and Business Organizations*, 2015, § 4.16 *Duty of Loyalty*.

[51] *Ibidem*.

[52] *Michelson v. Duncan*, 407 A.2d 211, 218-219, Supreme Court of Delaware, 1979.

of situations – first, when the director or the officer acts in a good faith but exceeds his or her scope of authority and second, when the director or the officer fails to reach an informed decision.[53] Conflicts involving a breach of the duty of loyalty could come either from a conflict-of-interest transaction between corporation and directors or from transaction between the corporation and its controlling shareholder.[54]

The DGCL, however, provides that no contract or transaction between a corporation and director or officer shall be void or voidable solely because directors (officers) are present at the meeting of the board which authorizes the contract or transaction if:

1) the material facts as to the director's or officer's relationship or interest and as to the contract or transaction are disclosed or are known to the board of directors and the board in good faith authorizes the contract or transaction by the affirmative votes of a majority of the disinterested directors, even though the disinterested directors be less than a quorum; or
2) the material facts as to the director's or officer's relationship or interest and as to the contract or transaction are disclosed or are known to the stockholders entitled to vote, and the contract or transaction is specifically approved in good faith by vote of the stockholders; or
3) the contract or transaction is fair as to the corporation as of the time it is authorized, approved or ratified, by the board of directors, a committee or the stockholders (DGCL § 144).

On the other hand, the MBCA § 8.62.b provides that if a director is involved in a conflicted transaction, but neither he nor a related person of the director is a party to the transaction, then disclosure of the material fact is sufficient if:

1) the director (officer) discloses to the directors voting on the transaction the existence and nature of his conflicting interest and informs them of the character and limitations imposed by that duty before their vote on the transaction, and
2) the director (officer) plays no part, directly or indirectly, in their deliberations or vote.

As a result of these provisions, the fiduciary has to prove that he or she disclosed all the material facts. This standard of proof is entire fairness (EF) standard,[55] not the BJR. The EF standard means that the court will consider both procedural (fair dealing) and substantive (fair price) aspects of the decision or transaction.[56] It is the most favorable of standard for plaintiffs in order to avoid dismissal at the pleadings stage.[57] The burden of proof is placed on the fiduciary, since the fiduciary must act with complete candor.[58] The key here

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[53] D.G. Smith, C.A. Williams, *Business Organizations*, *op. cit.*, p. 444.

[54] *Ibidem*, p. 445.

[55] *Weinberger v. UOP*, Inc., *op. cit.*

[56] *Weinberger v. UOP*, *op. cit.* and *Kahn v. Lynch Communication Systems Inc.*, 638 A.2d 1110, Supreme Court of Delaware, April 5, 1994.

[57] L.H. Lazarus, B.M. McCartney, *Standards of Review in Conflict Transactions on Motions to Dismiss: Lessons Learned in the Past Decade*, "Delaware Journal of Corporate Law", 2011, p. 975.

[58] L.H. Lazarus, B.M. McCartney, *Standards of Review…*, *op. cit.*, p. 976.

is that the directors or officers not only bear the burden of proof, but they must also justify both their decision making process and the substance of their decisions.[59]

The burden of proof might be shifted by the approval of the transaction or decision at issue and plaintiffs must allege that the transaction would not have been approved.[60] For example, in *Weinberger*, the Delaware Supreme Court stated that: "where corporate action has been approved by an informed vote of a majority of the minority shareholders, we conclude that the burden entirely shifts to the plaintiff to show that the transaction was unfair to the minority".[61]

Furthermore, if the self-dealing transaction was approved by disinterested directors or shareholders, that approval removes the taint of conflict of interest (*Wheelabrator*[62]). Fairness in such a case will be assessed under the BJR standard of review, as stated by the Delaware Court of Chancery: "Interested transactions, between corporation and its directors, or between corporation and entity in which corporation's directors are also directors or have financial interest, will not be voidable if transaction is approved in good faith by majority of disinterested stockholders; approval by fully informed, disinterested shareholders pursuant to statute invokes business judgment rule and limits judicial review to issues of gift or waste with burden of proof upon party attacking transaction."[63] Approval must be based on the full disclosure of material facts (*HMG v. GRAY*[64]) and must be conducted in a good faith. Thus, even if the transaction was approved, but not all of the material facts were disclosed, there is no safe harbor and the transaction is still voidable and the burden is placed on the fiduciary to show the EF.

On the other hand, in *Kahn v. Lynch*, the Supreme Court of Delaware stated that "entire fairness remains the proper focus of judicial analysis in examining an interested merger, irrespective of whether the burden of proof remains upon or is shifted away from the controlling or dominating shareholder, because the unchanging nature of the underlying 'interested" transaction requires careful scrutiny."[65] Thus, it is clear that entire fairness applies regardless of approval by disinterested directors or stockholders. Before *Kahn*, some cases had held that the business judgment doctrine applied to an interested-director transaction--and a showing of fairness was not required.[66] It seems, based on the *Wheelabrator*, that after *Kahn v. Lynch*, the BJR will be applied as well.

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[59] J. Velasco, *How Many Fiduciary Duties are there in Corporate Law?*, „Southern Carolina Law Review", 2010, p. 1242.

[60] B.A. Olson, *Publicly Traded Corporations: Governance & Regulation*, § 3.30 *The Entire Fairness Test – Overvie*w, 2014.

[61] *Weinberger v. UOP*, *op. cit.*

[62] *In re Wheelabrator Technologies Inc. Shareholders Litigation*, 663 A.2d 1194, Court Chancery of Delaware, May 18, 1995.

[63] *In re Wheelabrator…*, *op. cit.*

[64] *HMG/Courtland Properties Inc. v. Lee GRAY*, 749 A.2d 94, Court of Chancery of Delaware, July 12, 1999.

[65] *Kahn v. Lynch*, *op. cit.*

[66] R.F. Balotti, J.A. Finkelstein, *Delaware Law of Corporations and Business Organizations*, 2015, § 4.16 *Duty of Loyalty*.

3.2.1. Usurpation of corporate opportunity

The usurpation of corporate opportunity means taking advantage of something that should belong to the corporation. There are two different approaches to this issue, which allow to assess whether there indeed was an usurpation. Some courts require the opportunity to be presented under all circumstances (ALI approach, *Northeast Harbor Golf Club Inc. v. Harris*[67]). Other courts allow not to present the opportunity (which results in shifting the burden to the defendant, *Broz v. Cellular*[68]).

In *Northeast Harbor Golf Club* the court stated that the director or the officer may not take advantage of a corporate opportunity, involving a chance to engage in business activity of which director or senior executive becomes aware:

1) should lead him to believe that offeror expects it to be offered to corporation, or
2) through use of corporate information or property, or involving opportunity to engage in business activity closely related to business which corporation is engaged in or expects to engage in, unless director or senior executive offers opportunity to corporation and makes required disclosures, opportunity is rejected by corporation and rejection is either fair, opportunity is appropriately rejected in advance, or rejection is appropriately ratified.[69] The American Law Institute approach eliminates the possible defenses of incapacity or inability, financial or otherwise, of the corporation to take the opportunity.[70]

The test of misappropriation of opportunity belonging to the partnership was established in *Guth v. Loft* – the misappropriation does not exist when a corporation cannot take an opportunity because:

1) it lacks finances;
2) it is not in the same line of business;
3) the corporation has not "interest or reasonable expectancy";
4) the director or officer has not wrongfully employed the resources of the corporation in pursuing or exploiting the opportunity."[71]

The abovementioned criteria could be used to establish a way for the officer or the director to take a corporate opportunity if:

1) the opportunity is presented to the director or officer in his individual and not his corporate capacity;
2) the opportunity is not essential to the corporation;
3) the corporation holds no interest or expectancy in the opportunity;
4) the director or officer has not wrongfully employed the resources of the corporation in pursuing or exploiting the opportunity.[72]

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[67] *Northeast Harbor Golf Club Inc. v. Harris*, 661 A.2d 1146, Supreme Judicial Court of Maine, July 20, 1995.

[68] *Broz Inc. v. Cellular Information Systems Inc.*, 673 A.2d 148, Supreme Court of Delaware, April 11, 1996.

[69] *Northeast Harbor Golf Club Inc. v. Harris*, *op. cit.*

[70] 2 *Treatise on the Law of Corporations* (3d), § 11:8. *Misappropriation of corporate opportunities: disloyal diversion of business*, WestlawNext, access: 22.04.2015.

[71] *Guth v. Loft*, 23 Del.Ch. 255, Supreme Court of Delaware, April 11, 1939.

[72] *Broz v. Cellular*, *op. cit.*

When the conflict-of-interest transaction took place, there are three possible remedies:
1) rescission of the deal;
2) constructive trust on property;
3) corporation must be put in the position it should have been in absent of the breach.[73]

What if the self-dealing transaction arises between the corporation's shareholder and the corporation? In general, shareholders do not owe other shareholders fiduciary duties, unless the transaction concerns the controlling shareholder.[74] However, a shareholder who exercises control over or dominates a corporation's affairs is a fiduciary.[75] Transactions between the corporation and its controlling shareholder concern mainly parent-subsidiary mergers that were conditioned upon receiving "majority of the minority" shareholder approval.[76] The transaction would be examined under the entire fairness standard of review.[77]

When should the shareholder be perceived as the controlling one? No strict percentage of stock ownership automatically imposes fiduciary duties.[78] The fiduciary has to exercise control or dominance over the business and affairs of the corporation (*Kahn v. Lynch*). The control has to be actual not potential with regard to the challenged transaction, it is a matter of the power to work their will on others.[79]

3.3.2. Duty of oversight

The duty of oversight, as an element of the duty of loyalty, is strictly connected to good faith, another element of the duty of loyalty. Earlier, however, the duty of oversight was an element of the duty of care. Three cases are very important to understand the development and the meaning of oversight: *In re Caremark International Inc. Derivative Litigation*,[80] *Walt Disney*[81] and *Stone v. Ritter*.[82]

In the first case, the court established the *Caremark Claim*, which is based on the oversight liability and talks about the problem of "unconsidered inaction".[83] Actions of the board of directors constitute a breach of the duty of loyalty if the directors:

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[73] 4 *Causes of Action* 569 (Originally published in 1984), *Cause of Action for Misappropriation of Corporate Opportunity*, WestlawNext, access: 22.04.2015.

[74] F.H. O'Neal, R.B. Thompson, *Close Corp and LLCs…*, *op. cit.*

[75] *Maggiore v. Bradford*, 310 F.2d 519, 521 (6th Cir.1962).

[76] D.G. Smith, C. A. Williams, *Business Organizations*, *op. cit.*, p. 445.

[77] *Kahn v. Lynch Communication Systems, Inc.*, *op. cit.*

[78] M. Siegel, *The Erosion of the Law of Controlling Shareholders*, „Delaware Journal of Corporate Law", 1999, p. 35.

[79] M.A. Rosenhouse, *American Law Reports*, *Majority's Fiduciary Obligation to Minority Shareholder of Close Corporation – Breach and Remedy*, WestlawNext, access: 22.04.2015.

[80] *In re Caremark International Inc. Derivative Litigation*, 698 A.2d 959, Court of Chancery of Delaware, September 25, 1996.

[81] *In re the Walt Disney Company Derivative Litigation*, 2006 WL 1562466, Supreme Court of Delaware, June 8, 2006.

[82] *Stone v. Ritter*, 2006 WL 3169168, Supreme Court of Delaware, November 6, 2006.

[83] *Ibidem*.

1) utterly failed to implement any reporting or information system of controls; or
2) having implemented such a system of controls, consciously failed to monitor or oversee its operations thus disabling themselves from being informed.[84]

Thus, the failure has to be systematic or sustained.

Under the *Caremark Claim*, in order to prevail in court, the plaintiff must show:

1) That the directors knew or should have known that the violations of law were occurring, and
2) That the directors took no steps in a good faith effort to prevent or remedy the situation, and
3) That such failure proximately resulted in the losses complained of.[85]

Secondly, in *Walt Disney*,[86] the court stated that a fiduciary is in breach when he or she intentionally fails to act in the face of a known duty to act and that the intentional conduct has to exist. Furthermore, bad faith is more than acting without information and inadequate deliberation, which is a duty of care analysis.

Lastly, in *Stone v. Ritter*[87] the court stated that the failure to act in a good faith requires conduct that is more culpable than in the violation of the duty of care and that the good faith is an element of the duty of loyalty. Moreover, the good faith is not an independent fiduciary duty, but the lack of good faith means that the directors are not acting in the best interest of the corporation and are thus breaching their duty of loyalty.

4. Breach of fiduciary duties and litigation

What is the remedy to a breach of fiduciary duties? It is derivative suit, which serves as the cornerstone of shareholders' rights to monitor the conduct and behavior of directors and officers of the corporation.[88] Shareholders can sue on behalf of the corporation for the harm done to the corporation.[89] The procedure is "derivative" because the corporation is the one that suffers directly and the shareholders "derive" the claim from the corporation. In order to determine whether the suit should be derivative or direct, one must ask oneself the following questions: 1) Who suffered the alleged harm? The corporation or shareholders individually? 2) Who would receive the benefit of the recovery or other remedy?[90] When the corporation is the one who suffers the harm and the corporation would receive the benefit, then the suit is of derivative nature.

Four procedural requirements have to be met in order for the shareholders to be able to file a derivative suit:[91]

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[84] *Ibidem*.

[85] *Ibidem*.

[86] *In re the Walt Disney Company Derivative Litigation*, *op. cit*.

[87] *Stone v. Ritter*, *op. cit*.

[88] E. Farinacci, *In a bind: mandatory arbitration clauses in the corporate derivative context*, „Ohio State Journal on Dispute Resolution", 28/2013, p. 748.

[89] D.G. Smith, C.A. Williams, *Business Organizations…*, *op. cit.*, p. 479.

[90] *Ibidem*, p. 478.

[91] *Ibidem*, p. 464.

1) Plaintiffs must have been shareholders at the time of the alleged breach of duty ("contemporaneous ownership rule").
2) Plaintiffs must remain shareholders throughout the litigation ("standing requirement"), *Lewis v. Anderson*.[92]
3) Shareholders must demand that the board of directors take action before the shareholder assumes control of the litigation ("demand requirement").
4) Once a derivative claim is filed, the court must approve any settlement.

The most important of these requirements is the demand one. It is difficult to meet because the directors have discretion to refuse to sue if they decide in good faith not to do so and do not exceed the scope of the business judgment rule.[93] There are two approaches to the demand requirement – the first one requires that the demand must be made under all circumstances and the second one allows the demand to be excused under certain circumstances.[94]

4.1. MBCA Approach (Universal Demand Requirement)

Under § 7.42 of the MBCA, the demand is universal under all circumstances. No shareholder may commence a derivative proceeding until:

1) a written demand has been made upon the corporation to take suitable action; and
2) 90 days have expired from the date the demand was made unless the shareholder has earlier been notified that the demand has been rejected by the corporation or unless irreparable injury to the corporation would result by waiting for the expiration of the 90 day period.

4.2. Delaware approach.

Under the Delaware rules, the demand could be either required or excused. If the demand is made and directors refuse to act, the court will review the board's decision to refuse the demand ("wrongful refusal" cases).[95] The decision to refuse the demand is reviewed under the BJR.[96] On the other hand, a demand is futile if directors would not be willing to act upon a demand as a result of some conflict of interest or if the challenged action presents a real risk of fiduciary liability. More careful scrutiny is required if the allegations in the plaintiff's complaint raise a reasonable inference that the BJR is not applicable for purposes of considering a pre-suit demand pursuant to Rule 23.1. *Delaware Chancery Rules*.[97] Under *Aronson v. Lewis*,[98] plaintiffs have to create a reasonable doubt as to the disinterest or

[92] *Lewis v. Anderson*, 477 A.2d 1040, Supreme Court of Delaware, April 18, 1984.

[93] *Treatise on the Law of Corporations*, Chapter XV, *The Derivative Suit*, § 15:7 *The demand on the directors requirement*, WestlawNext, access: 22.04.2015.

[94] R.F. Balotti, J.A. Finkelstein, *Delaware Law of Corporations and Business Organizations*, § 13.12 *Requirements of Rule 23.1*, WestlawNext, access: 22.04.2015.

[95] *Treatsie on the Law of Corporations*, Chapter XV, *The Derivative Suit*, § 15:7, *op. cit.*, access: 23.04.2015.

[96] *Ibidem*.

[97] *Delaware Chancery Rules*, DE R CH CT.

[98] *Aronson v. Lewis*, 473 A.2d 805, Supreme Court of Delaware, March 1, 1984.

independence of a majority of the corporation's directors.[99] As the court stated: "Where officers and directors are under an influence which sterilizes their discretion, they cannot be considered proper persons to conduct litigation on behalf of the corporation."[100] The court furthermore stated that: "In determining demand futility the Court of Chancery in the proper exercise of its discretion must decide whether, under the particularized facts alleged, a reasonable doubt is created that

1) the directors are disinterested and independent; or
2) the challenged transaction was otherwise the product of a valid exercise of business judgment."[101]

Directors are entitled to a presumption that they were faithful to their fiduciary duties. The burden is on the plaintiff to overcome that presumption.[102] Thus, based on the analyzed case, the court must determine whether a plaintiff has alleged particularized facts creating a reasonable doubt about a director's independence to rebut that presumption. Pleaded facts must create a reasonable doubt that a majority of the board could have acted independently in responding to a demand.

In addition, lack of independence might occur due to familial relationship.[103] In this case, plaintiff must plead particularized facts that create a reasonable doubt sufficient to rebut the presumption of director independence.[104] The relationship must be of a bias-producing nature – it must be so close that the director's independence may reasonably be doubted.[105] In *Beam ex rel. v. Stewart* the court furthermore stated that the doubt may arise either because of financial ties, familial affinity, a particularly close or intimate personal or business affinity or because of evidence that in the past the relationship caused the director to act non-independently.[106]

5. Summary and Conclusion

Directors and officers, as the fiduciaries of the corporation, owe fiduciary duties to the corporation itself and its shareholders. The most important of these duties are the duties of care and loyalty. Directors and officers are, however, entitled to a presumption that they were faithful to their fiduciary duties. Furthermore, breaching fiduciary duties does not automatically lead to liability for a director, because corporate law is based on the distinction between standards of conduct and standards of review. The standard of review is the test applied by courts to determine if the managers complied with the standard of conduct and

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[99] D.A. DeMott, D.F. Cavers, *Shareholder Derivative Actions: Law and Practice*, § 5.13 *Demand on directors – Criteria for excuse*, WestlawNext, access: 23.04.2015.

[100] *Aronson v. Lewis*, *op. cit.*

[101] *Ibidem*.

[102] *Ibidem*.

[103] *Aronson v. Lewis*, *op. cit.* and *Grimes v. Donald,* 673 A.2d 1207, 1216, Supreme Court of Delaware, April 11, 1996.

[104] *Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart*, 845 A.2d 1040, Supreme Court of Delaware, March 31, 2004.

[105] *Ibidem*.

[106] *Ibidem*.

whether the liability could be imposed on them. The standards of review applied to the disputes regarding fiduciary duties are the Business Judgment Rule and the Entire Fairness.

The duty of care is measured by the standard of an ordinarily prudent person and viewed under the BJR standard of review. A corporation may provide an exculpation clause in its charter, which would limit or eliminate the liability for money damage in connection with the breach of the duty of care. Since the BJR is a presumption, the burden of proof is placed on the plaintiff – shareholders. The court wouldn't second-guess the merits of the decision and it would analyze only the procedural aspect of the decision.

The duty of loyalty exists when the director stands on both sides of the transaction at issue or otherwise receives a personal benefit and is strictly related to the conflict of interest. The duty of good faith is an element of the duty of loyalty. In order to determine whether there was a breach of the duty of loyalty, one must answer a few questions: Did the decision maker disclose all the material information? Was there approval of the disinterested shareholders or directors? Who bears the burden of proof? The plaintiff or the defendant? Was the transaction fair to the company? In general, the fiduciary bears the burden of proof. It might be, however, shifted by the approval of the transaction or decision at issue and plaintiffs must allege sufficiently that the transaction would not have been approved.

With regard to the usurpation of corporate opportunity, which means taking advantage of something that should belong to the corporation, there are two different approaches. Some courts require the opportunity to be presented under all circumstances (ALI approach), other courts allow not to present the opportunity under certain circumstances.

The derivative suit is a remedy for breach of fiduciary duties. Shareholders can sue on behalf of the corporation for the harm done to the corporation. The procedure is called the derivative suit as the corporation is the one, who suffers directly. If the corporation would receive the benefit, then the suit is of a derivative nature. There are four procedural requirements, which have to be met cumulatively for the shareholders to be able to file a derivative suit: contemporaneous ownership rule, standing requirement, demand requirement, once a derivative suit is filed, the court must approve any settlement.

Unfortunately, given the standards of review and the burden of proof, it is really difficult for shareholders to enforce control over directors and officers. The presumption of the managers being faithful to the corporation, works in favor of the directors and officers. Furthermore the procedural aspects of the derivative suit make holding managers liable not easy. It has been an important question whether the ways to protect shareholders are sufficient and many scholars believe that it is not.

Post-*Enron* legislation was supposed to ensure that the drawbacks of risk taking would be mitigated by much more careful scrutiny and transparency of all the undertakings. Unfortunately, the mechanisms of control are not perfect and they still need to be evaluated in order to prevent future scandalous collapses of corporations. Perhaps a cohesive and uniformed regulation would be the proper remedy. In any event, it can be stated without a doubt that applying more restrictive procedures and introducing new substantive requirements for managers will provide a better shield for all the stakeholders against misconduct of the directors and officers.

Obowiązki powiernicze członków rady administrującej oraz dyrektorów względem spółki akcyjnej oraz jej udziałowców w Stanach Zjednoczonych

Streszczenie

Obowiązki powiernicze członków rady administrującej oraz dyrektorów względem amerykańskiej spółki akcyjnej oraz jej udziałowców mają z punktu widzenia systemu *common law* istotne znaczenie dla kontroli i nadzoru nad sprawowaniem zarządu. W Stanach Zjednoczonych, zasadniczo, kompetencje osób zarządzających spółką są szersze niż w systemie prawa kontynentalnego. Przyjęty monistyczny system administrowania spółką powoduje, że uprawnienia zarządcze oraz kontrolne sprawowane są przez ten sam organ – radę administrującą. Domniemanie prawidłowego wykonywania obowiązków powierniczych przez osoby zarządzające oraz brak możliwości oceny decyzji tych osób przez sąd pod kątem merytorycznym w razie wytoczonego przeciwko nim powództwa, sprzyjają rozwojowi gospodarczemu. Chociaż takie uregulowania skłaniają osoby zarządzające do podejmowania bardziej ryzykownych decyzji (co w szerszej perspektywie przynosi zyski), istnieje zagrożenie, że w razie naruszenia obowiązków powierniczych szkoda wyrządzona spółce pozostanie nienaprawiona. Osoby zarządzające mają względem udziałowców oraz samej spółki obowiązek dochowania należytej staranności oraz lojalności. Co do zasady, w przypadku zarzutów naruszenia obowiązku dochowania należytej staranności, ciężar dowodu spoczywa na powodzie, natomiast w przypadku naruszenia obowiązku lojalności, ciężar dowodu spoczywa na pozwanym.