# Shaping The Contours Of Corporate Fiduciary Duties

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## ABSTRACT

*The article will briefly identify the common law fiduciary duties that corporate managers and majority shareholders owe to the corporation and its shareholders, discuss how courts have addressed shareholder efforts to contract around such duties, and conclude by attempting to square seemingly inconsistent judicial doctrines, where courts have both prohibited blanket limitations on fiduciary duties and rejected fiduciary duty claims by relying on contractual limitations. The article seeks to help co-venturers better understand and shape the duties they owe to each other and their corporation at the outset of a business relationship.*

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## I. INTRODUCTION

Judge Cardozo is rightfully praised for his poetic description of the fiduciary duty of loyalty: "something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor most sensitive . . . ."[2] But his turn of phrase, like that of many other common law judges, is more impressive aesthetically than helpful to a business owner, director, shareholder, or investor attempting to understand the scope and contours of that duty.

The able transactional lawyer charged with crafting formational documents—e.g., articles of incorporation, bylaws, or shareholder agreements—can play an invalu-

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2. Meinhard v. Salmon, 249 N.Y. 458, 464 (1928).

able role in helping parties define their fiduciary duty rules of the road. Parties may want to, among other things: (1) limit whether and how shareholders can exercise their voting, appraisal, and inspection rights; (2) exclude certain considerations from management decisions; (3) provide drag-along rights to majority shareholders and correspondingly limit other shareholders' rights in certain transactions; and (4) specify a forum for litigation or even limit the right to bring litigation. Interestingly, state statutory law allows alternative entities, such as limited liability companies, the freedom to expressly define, modify, and even eliminate fiduciary duties through the entity's organizational documents and operating agreements. Surprisingly, however, there has been scant focus on the law governing corporations, including whether and how a corporation's governing documents or a shareholders' agreement can alter default fiduciary duties.

**Co-venturers and their business lawyers should specify the scope of the rights and duties they owe each other at the outset of a business relationship.**

Experienced trial lawyers who have litigated many intra-company disputes will know that disputes among partners or shareholders often end up turning on the interpretation of the fiduciary obligations they owe each other. More often than not, one side supports its interpretation of the fiduciary obligation owed by appealing to the language of the parties' controlling agreement, while the other finds support in less well-defined common law fiduciary principles of the sort expounded by Judge Cardozo.

One may be sympathetic to parties who seek, *ex ante*, to define the scope of the fiduciary duties they owe each other. That effort allows parties to decide with whom they want to co-venture and on what terms. It also creates a set of rules and expectations that all of the participants understand and know to follow. And it establishes the standards for judging the parties' conduct *ex post*. Unfortunately, however, that helpful practice is often frustrated—or, at the very least, rendered more difficult—by the law's imposition of various constraints on corporations' ability to narrowly define parties' fiduciary obligations to each other. These constraints may impede transactional attorneys' efforts to draft enforceable agreements that adhere to their clients' directives.

This article is intended to help co-venturers and their transactional lawyers to better understand and navigate these constraints. It first identifies the common law fiduciary duties that corporate managers and majority shareholders owe to the corporation and its shareholders, highlighting the statutory developments that have allowed the limited ability to alter those duties. It then discusses how courts have addressed shareholder efforts to contract around such duties, particularly in closely-held corporations. It concludes by attempting to square seemingly inconsistent (albeit underdeveloped) judicial doctrines, whereby courts have both (1) prohibited blanket limitations on fiduciary duties and (2) rejected fiduciary duty claims by relying on contractual limitations, so that co-venturers can more predictably shape the duties they owe to each other and their corporation at the outset of a business relationship.

## II. CORPORATE FIDUCIARY DUTIES

Corporate managers owe multiple fiduciary duties to both the corporation and its shareholders, including the duties of due care and loyalty.[3] The duty of care requires

3. *See, e.g.*, Malone v. Brincat, 722 A.2d 5, 10 (Del. 1998); Viener v. Jacobs, 834 A.2d 546, 556 (Pa. Super. Ct. 2003). Directors, officers, and controlling shareholders also owe minority shareholders a duty of disclo-

corporate managers to discharge their duties with diligence and to exercise informed business judgment; the duty of loyalty requires that managers promote the common interests of the entity over their own interests and not obtain any advantage other than that enjoyed equally by all shareholders, including by misappropriating corporate assets, engaging in self-interested transactions, or usurping corporate opportunities.

Majority shareholders likewise owe these duties to minority shareholders and cannot engage in conduct that deprives minority shareholders of the benefits of ownership. A majority of states, including Pennsylvania and New Jersey, have codified this protection for minority shareholders in closely-held corporations (generally defined as corporations having 25 or fewer shareholders) by enacting statutes authorizing minority shareholders to obtain equitable relief if the majority engages in acts of "oppression."[4] Delaware, by contrast, has not codified this protection, but provides a judicially created cause of action for minority shareholder oppression.[5]

"Oppression" means different things in different states. The most frequently used standard to determine if a majority shareholder's conduct is oppressive is whether it substantially defeats the reasonable expectations held by minority shareholders.[6] This abstract standard is highly fact-intensive and requires a deep historical inquiry into not only the formation of the enterprise but also agreements between the shareholders and the shareholders' dealings with each other during the life of the company.

## III. STATUTORY EVOLUTION OF THE POWER TO ALTER FIDUCIARY DUTIES

Much of entity law consists of default rules that parties may freely alter.[7] In sharp contrast, the fiduciary duties of care and loyalty in the context of corporations are generally understood to be immune to private efforts to modify or eliminate them.[8] Nonetheless, while state statutory law, including in Pennsylvania, Delaware, and New Jersey, makes these fiduciary duties obligatory,[9] they are not entirely inflexible.

The duty of care, for example, can be effectively limited in multiple ways. Not only are most corporate managers' decisions protected by the business judgment rule, which provides a presumption that such decisions were made on an informed basis and in good faith, but the majority of states have allowed corporations to effectively contract around the duty of care by statutorily eliminating the personal liability of corporate directors for any breaches, assuming the director did not otherwise breach his/her duty of loyalty.[10]

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sure (or candor) regarding facts surrounding a transaction involving the minority. *See* Lynch v. Vickers Energy Corp., 383 A.2d 278, 281 (Del. 1977); O'Reilly v. Transworld Healthcare, Inc., 745 A.2d 902, 916 (Del. Ch. 1999).

4. 15 Pa.C.S.A. §1767(a)(2); N.J.S.A. 14A:12-7(1)(c).

5. *See, e.g.*, Little v. Waters, 18 Del. J. Corp. L. 315, 327, 1992 WL 25758 (Del. Ch. Feb. 11, 1992).

6. Ford v. Ford, 878 A.2d 894, 900 (Pa. Super. 2005); Brenner v. Berkowitz, 634 A.2d 1019, 1027 (N.J. 1993).

7. *See, e.g.*, Rauterberg, Gabriel & Eric Talley, *Contracting Out of the Fiduciary Duty of Loyalty: An Empirical Analysis of Corporate Opportunity Waivers*, 117 Colum. L. Rev. 1075, 1077 (2017).

8. *See, e.g.*, Paramount Communications Inc. v. QVC Network Inc., 637 A.2d 34, 48 (Del. 1994) ("[Contractual] provisions, whether or not they are presumptively valid in the abstract, may not validly define or limit the directors' fiduciary duties under Delaware law. . ."); Rauterberg et al., *supra* note 7, at 1077.

9. 15 Pa.C.S.A. §1718 ("[A]rticles [of incorporation] may not contain any provision that relaxes, restricts, is inconsistent with or supersedes any provision of this subchapter [relating to fiduciary duties]"); 8 Del. C. §102(b)(7); (cannot relieve director of officer from liability for breach of duty of loyalty or failure to act in good faith); N.J.S.A. 14A:2-7(3) (same).

10. Delaware and Pennsylvania provide this protection to only directors, not officers or controlling shareholders. 8 Del. C. §102(b)(7); 15 Pa.C.S.A. §1713(a). New Jersey, in contrast, extends this protection to both directors and officers. N.J.S.A. 14A:2-7(3).

The last two decades have also seen some relaxation of the duty of loyalty. After multiple failed attempts by corporations to effectuate limited waivers of the duty of loyalty, Delaware amended its corporate law in the year 2000 to permit corporations to waive one aspect of this duty—namely, the prohibition on corporate fiduciaries taking new business opportunities for themselves without first offering them to the company.[11] New Jersey followed suit ten years later.[12] (Pennsylvania, by contrast, has not adopted any statutory abrogation of the duty of loyalty.) Prior to these enactments, fiduciaries of Delaware and New Jersey corporations needed to first fully disclose to the corporation's board any opportunity that could potentially benefit the corporation, and the board had to formally decline the opportunity on the corporation's behalf before the fiduciary could take the opportunity for him or herself.

These relatively narrow statutory exceptions contrast sharply with the far greater flexibility afforded to alternative entities such as limited liability companies. As LLCs have become increasingly popular during the last three decades, states have gradually allowed them to alter (and even eliminate) fiduciary duties that members owe to the entity and each other. In the past few years, Delaware has made clear that, absent agreement to the contrary, managing members of an LLC owe fiduciary duties,[13] but those duties can be eliminated or limited by express language in the entity's operating agreement.[14] As the Delaware Chancery Court explained in rejecting a breach of fiduciary duty claim against a majority member of an LLC, "an alternative entity agreement that waives all fiduciary duties implies an agreement that losses should remain where they fall rather than being shifted after the fact through fiduciary duty review," and LLC members are free to allocate risk in that manner.[15] Similarly, New Jersey and Pennsylvania revised their limited liability company laws in 2012 and 2017, respectively, to, among other things, permit an LLC to eliminate fiduciary duties entirely or designate specific types of activities that do not violate such duties.[16]

Against this statutory backdrop, courts have navigated contractual alterations and waivers of fiduciary duties in the corporate context.

## IV. CONTRACTING AROUND CORPORATE FIDUCIARY DUTIES

Surveying the judicial landscape, two principles become clear: blanket contractual waivers of fiduciary duties are unenforceable with respect to the governance of corporations, but limited waivers may be valid.

Although blanket contractual waivers of fiduciary duties have rarely been tested in litigation, in the few instances in which they have been tested, they have been resoundingly rejected. For instance, a California appellate court held that "waiver of corporate directors' and majority shareholders' fiduciary duties to minority shareholders in private close corporations is against public policy, and a contract provision in a buy-sell agreement purporting to effect such a waiver is void."[17] Similarly, in Delaware, courts contrast shareholders' inability to eliminate fiduciary duties in

11. 8 Del. C. §122(17).
12. N.J.S.A. 14A:3-1(1)(q).
13. 6 Del. C. §18-1104 (effective Aug. 1, 2013).
14. 6 Del. C. §18-1101(c).
15. Miller v. HCP & Co., CA. No. 2017-0291-SG, 2018 WL 656378, at 10 (Del. Ch. Feb. 1, 2018) (citation and quotation marks omitted).
16. *See* N.J.S.A. 42:2C-11(d); 15 Pa.C.S.A. §8815(d).
17. Neubauer v. Goldfarb, 108 Cal. App. 4th 47, 57 (2003).

the corporate context, which have been established by the common law, with their ability to do so in the alternative-entity space, which have been established by statute.[18]

But in a seemingly inconsistent line of cases, courts have condoned limited contractual waivers of certain fiduciary protections involving, among other things, buyout rights, access to information, and employment. For example, in *Coleman* v. *Taub*, the U.S. Court of Appeals for the Third Circuit, applying Delaware law, rejected a minority shareholder's breach of fiduciary duty claim arising from the corporation's termination of the shareholder's employment and subsequent cash-out merger, finding that the operative shareholder agreement "altered the fiduciary duty in such a way that a freeze-out merger under the circumstances may not have been a breach of defendants' duty."[19] The court explained that, while a "minority takeout constitutes a breach of the majority's fiduciary duty when the purpose of the takeout is simply ridding the corporation of the minority," contractual language can under some circumstances "insulate a freeze-out merger from attack."[20] The court rejected the shareholder's "appeal to general fiduciary law . . . as a pretext for evading his contractual obligations."[21]

Two decades later, the Third Circuit doubled down on this reasoning, finding that a shareholder had waived his right to information about future events which may affect the value of his shares, because the shareholder's agreement he signed expressly stated that the corporation need not "disclose any event or transaction that may have occurred or be proposed or pending at the time of any [stock] sale."[22] Notably, the court did not even acknowledge the multitude of cases prohibiting blanket waivers of fiduciary duties.

Contractual waivers of fiduciary duties have been most frequently litigated in the context of the termination of shareholders' employment, with the majority of courts across the country rejecting fiduciary duty and oppression claims when a shareholder agreement contains a provision providing for termination without cause or at-will employment.[23] In those circumstances, courts have been hard-pressed to find that the terminated shareholder had a reasonable expectation of continued employment so as to constitute shareholder oppression.

## V. NAVIGATING SEEMINGLY INCONSISTENT JUDICIAL DOCTRINES

The prior two sections identify, on the one hand, statutes and judicial decisions that prohibit any limitation on a corporate manager's or shareholder's fiduciary du-

18. Dieckman v. Regency GP LP, C.A. No. 11130-CB, 2016 WL 1223348, at 8 (Del. Ch. Mar. 29, 2016) ("[I]n stark contrast to the corporate context, in which fiduciary duties cannot be waived, a limited partnership may eliminate all fiduciary duties, including the duty of disclosure."), *rev'd on other grounds*, 155 A.3d 358 (Del. 2017).

19. 638 F.2d 628, 638 (3d Cir. 1981).

20. *Id*. at 635-36.

21. *Id*. at 636. Similarly, the Ninth Circuit upheld a buyout provision in a shareholder agreement that was more favorable to the majority shareholder than the minority, finding that such a limited waiver does not run afoul of California's public policy prohibiting wholesale contractual waivers of fiduciary duties. Kaul v. Mentor Graphics Corporation, 730 Fed.Appx. 437, 439 (9th Cir. 2018) (distinguishing *Neubauer, supra* note 17); *see also* BML Properties Ltd. v. China Construction America, Inc., No. 657550/2017, 2020 WL 1274238, at *4-5 (N.Y. Sup. Ct., Mar. 17, 2020) (dismissing common law breach of fiduciary duty claim under New York law because parties waived such duties in agreement).

22. Houston v. Aramark Corp., 112 F. App'x 132, 136-37 (3d Cir. 2004).

23. *See, e.g.*, Regan v. Natural Resources Group, Inc., 345 F. Supp. 2d 1000, 1012 (D. Minn. 2004); Gallagher v. Lambert, 74 N.Y.2d 562, 567 (N.Y. 1989); Hayes v. Northern Hills General Hospital, 628 N.W.2d 739, 747 (S.D. 2001); *but see* Orchard v. Covelli, 590 F. Supp. 1548, 1556-58 (W.D. Pa. 1984) (dismissing wrongful termination claim because shareholder was an employee at-will but finding that termination may breach fiduciary duties owed to shareholder).

ties with, on the other hand, cases that have rejected fiduciary duty claims by relying on contractual limitations to shareholder rights and responsibilities. How do co-venturers looking to form a business relationship, and the business lawyers they hire to advise them, navigate this doctrinal inconsistency? It is not easy, because there is no clear-cut way to reconcile the divergent decisions. As former Pennsylvania Supreme Court Chief Justice Saylor acknowledged more than two decades ago: "Whether, and to what extent, parties may contractually alter or eliminate such duties implicates an extensive, ongoing debate in the legal community . . . ."[24] That debate has not yet been resolved.

But a fair reading of the cases that have permitted contractual alterations of such duties shows that the limited "waivers" at issue are not actually waivers at all. Rather, they are interpretive tools that shareholders (and courts) can use to apply fiduciary duties to particular facts and circumstances. Fiduciary duties are rooted in fairness,[25] and what is "fair" cannot be determined in a vacuum; rather, one must look to things like the corporation's formational documents and agreements between the shareholders to understand the shareholders' relationships with each other and the corporation. Paradoxically, then, fiduciary duties in the corporate context are both immutable and malleable: although a corporation cannot eliminate fiduciary duties *in toto*, it can shape the content of those duties *ex ante*.

## VI. CONCLUSION

Co-venturers and their business lawyers, therefore, should not shy away from specifying the scope of the rights and duties they owe each other at the outset of a business relationship, whether in the entity's articles of incorporation, its bylaws, or a shareholders agreement.[26] To be sure, one cannot eliminate entirely the "complexities associated with compliance with such loosely-defined duties."[27] But giving life to abstract fiduciary duties will necessarily inform and affect application of these duties down the road and may save substantial time and money in the event of a dispute.

24. Warehime v. Warehime, 761 A.2d 1138, 1142 (Pa. 2000) (Saylor, J., concurring).

25. *See, e.g., Orchard, supra* note 23, at 1556.

26. This article does not differentiate between these different types of private ordering. In a forthcoming article, Professor Jill Fisch argues that private ordering should be limited to a corporation's formational documents (i.e., its articles of incorporation and bylaws), and that corporate participants should not have "unlimited freedom" to modify or limit corporate fiduciary duties via shareholder agreement. *See* Jill E. Fisch, *Stealth Governance: Shareholder Agreements and Private Ordering*, (Mar. 1, 2021 draft), Faculty Scholarship at Penn Law, at p. 38, forthcoming at 99 Washington Univ. L. Rev. (2022), *available at* https://scholarship.law.upenn.edu/cgi/viewcontent.cgi?article=3201&context=faculty_scholarship. This distinction is outside the scope of this article.

27. Warehime, 761 A.2d at 1143 (Saylor, J. concurring).