A Review of Fiduciary Duties in California and Delaware Corporations

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Introduction

The legal community and the press have focused much attention on the responsibilities of corporate officers and directors under the federal Sarbanes Oxley Act. In addition, the daily press has been replete with examples such as the Enron litigation demonstrating the federal criminalization of corporate law. The advantages and disadvantages of the increasing federalization of the duties owed in the corporate context have been, and will continue to be, a source of debate.[2] However, the business practitioner, and particularly, the business litigator in California, will most often look to the principles of state fiduciary duty law to evaluate potential claims within the corporate context. Given the historical predilection for incorporation in Delaware, the California lawyer practicing in this area should have familiarity with both Delaware and California law. This article seeks to present a brief summary of fiduciary duties in the corporate context under the laws of both states.

The corporation presents potential fiduciary duty issues for shareholders, directors, officers, employees, and promoters. It is often stated that shareholders do not owe a fiduciary duty in their capacity solely as shareholders to either the corporation or other shareholders. (See *Jones v. H.F. Ahmanson & Co.* (1969) 1 Cal.3d 93.) The *Jones* case did identify certain circumstances in which a fiduciary duty may be imposed under California law: when a majority shareholder usurps a corporate opportunity from, or otherwise harms, the minority shareholder. (*Id.* at p. 108.; *Miles, Inc. v. Scripps Clinic and Research Foundation* (S.D. Cal. 1993) 810 F.Supp. 1091, 1099 (applying California law, "The general rule of limited liability of corporations is that shareholders do not owe each other a fiduciary duty.); *Ivanhoe Partners v. Newmont Min. Corp.* (Del. 1987) 535 A.2d 1334, 1344 (Under Delaware law a shareholder owes a fiduciary duty only if it owns a majority interest in or exercises control over the business affairs of the corporation.)

A careful analysis suggests that one must consider whether the corporation is closely held and whether the shareholder is a controlling shareholder. In both California and Delaware, as in other jurisdictions, it has been held that the controlling shareholder owes a fiduciary duty to both the corporation and the minority shareholders.

In closely held corporations, there are two principal views of the fiduciary duty of shareholders. Massachusetts and a number of other jurisdictions have adopted what has been characterized, probably improperly, as the "majority" view. This view holds that, at least in a closely held corporation, *all* officers, directors, and shareholders are fiduciaries of each other and, in that capacity, owe each other a heightened fiduciary duty, similar to that which partners owe each other in a partnership.

Delaware follows what has been characterized as the "minority" view that controlling shareholders, at least in closely held corporations, like officers and directors, owe fiduciary duties to the corporation. (See, e.g., *Hollinger International, Inc. v. Black* (Del. 2004) 844 A. 2d 1022, 1061, fn. 83; *In re Summit Metal, Inc.* (D.Del. 2004) Westlaw 1812700, *12.) A shareholder need not own a majority of the corporation's share to be a "controlling shareholder." Thus, even if a shareholder owns less than 50% of the outstanding shares, if that shareholder exercises domination through actual control of corporate conduct, the shareholder can be deemed a controlling shareholder. (See *Citron v. Fairchild Camera & Instrument Corp.* (Del. 1989) 569 A.2d 53, 70; *Ivanhoe Partners v. Newmont Mining Corp.* (Del. 1987) 535 A.2d 1334, 1344.) The duties for controlling shareholders as expressed in at least some Delaware cases appear to be owed to the corporation only; California cases hold that the duties are owed to both the corporation and other shareholders. The controlling shareholder in a Delaware corporation, unlike a partner in a general partnership who owes a fiduciary duty to all other partners, does not owe a fiduciary to the other shareholders. Under Delaware law, however, a controlling shareholder may vote his shares in his own self-interest even if that interest is contrary to the corporation's best interest. (*Thorpe, et al. v. CERBCO, etc.* (Del. 1996) 676 A.2d 436 (controlling shareholders have a right to vote as shareholders in their own self-interest).)

In both Delaware and California, the fiduciary duties owed by a controlling shareholder include the duties of loyalty and care. The application of those duties in Delaware are often presented in the context of alleged self-dealing transactions (i.e. where the controlling shareholder is effectively on both sides of the transaction). Self-dealing is not per se invalid under Delaware law, but rather is subject to the entire fairness test. By being on both sides of the transaction, the controlling shareholder bears the burden of proving the entire fairness of the transaction. (*Kahn v. Tremont, Corp.* (D.Del. 1997) 694 A.2d 422, 428; *Lynch Communication Sys. Inc.* (D.Del. 1994) 638 A.2d 110, 1115.) Delaware courts also apply the entire fairness test wherever the fiduciary will receive a financial benefit from the transaction at issue that is not equally shared by all the stockholders. (*In re LNR Property* (Del. Ch. 2005) 896 A.2d 169, 175.) It has been held that the disparity must be more than a *de minimus* departure from equal treatment. (*McGowan v. Ferro* (D.Del. 2004) 859 A.2d 1012, 1029.)

Entire fairness has two components: fair dealing and fair price. Fair dealing includes such factors as when the transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how approvals were obtained. Fair price relates to the economic and financial consideration for the deals. (See *Weinberger v. UOP, Inc.* (D.Del. 1983) 457 A.2d 701703.)

California case law provides authority indicating that a controlling shareholder owes fiduciary duties to both the corporation and the minority shareholders. (See, e.g., *Stephenson v. Dreyer,* (Cal. 1997) 16 Cal.4th 1167, 1178 (stating that controlling shareholder's fiduciary duties include good faith, inherent fairness and equal opportunity for minority shareholders); *Jones v. Ahmanson & Co.* (Cal. 1969) 460 P.2d 464, 471 (holding that any use of the corporation or controlling power must benefit all shareholders equally).) In *Stephenson,* a minority shareholder and former employee brought an action against the majority stockholder of a closely held corporation and two of its officers and directors for breach of fiduciary duty and misuse of corporate assets. The plaintiff was a party to a buy-sell agreement giving the corporation the right (and obligation) to repurchase the shares of the minority shareholder on the termination of his employment. The precise issue presented was whether the agreement, on its face, implied an intention to deny the minority shareholder his rights post-employment but before the shares were transferred. The California Supreme Court held it did not. The court explained that corporate shareholders have valuable property rights including the right to dividends voted by the boards. The court concluded that, since the plaintiff was the only minority shareholder, the directors and the majority shareholders had fiduciary duties to the minority shareholders:

> Majority shareholders may not use their power to control corporate activities to benefit themselves alone or in a manner detrimental to the minority. Any use to which they put the corporation or their power to control the corporation must benefit all shareholders proportionately and must not conflict with the proper conduct of the corporation's business." [*Jones v. H.F. Ahmanson & Co.* (1969) 1 Cal.3d 93, 108] adopted "the comprehensive rule of good faith and inherent fairness to the minority in any transaction where control of the corporation is material" (*id.* at p. 112), and declared broadly that "[t]he rule applies alike to officers, directors, and controlling shareholders in the exercise of powers that are theirs by virtue of their position and to transactions wherein controlling shareholders seek to gain an advantage in the sale or transfer or use of their controlling block of shares." (*Id.* at p. 110.)
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> *Stephenson v. Dreyer* (1997) 14 Cal. 4th at 1178.

The *Stephenson* court quoted *Jones v. Ahmanson & Co., supra,* 460 P.2d 464 at p. 110, holding that majority shareholders may not use their power to control corporate activities to benefit themselves alone or to the detriment of the minority and that any use of the power to control the corporation must benefit the shareholders, "proportionately and must not conflict with the proper conduct of the corporation's business." (*Jones. v. Ahmanson & Co., supra,* 1 Cal.3d at p. 108.)

In *Jones v. H.F. Ahmanson,* a minority stockholder in a savings and loan association brought a derivative action against a holding company formed by defendant majority stockholders and officers of the association. Essentially, the plaintiff contended that to take advantage of a bull market in savings and loan stock, the majority stockholders formed a holding company, transferring to it the control block of association stock in exchange for a considerably greater number of holding company shares, excluding the minority stockholders from participating therein, pledging the association's assets and earnings to secure the holding company's debt that had been incurred for their own benefit, and finally, having thus left the minority with stock whose potential market had been destroyed, using that very fact as a basis for offering to buy stock at an exchange rate less favorable than they themselves had enjoyed. In addition, the majority through the newly formed holding company caused the savings and loan association to cease paying dividends, other than the regular $4.00 per share annual dividend, although extra large dividends had previously been paid.

The California Supreme Court held that California no longer follows the rule recognizing the right of majority stockholders to dispose of their stock without the slightest regard to the wishes or knowledge of the minority. The prevailing rule is that of inherent fairness from the viewpoint of the corporation and of those interested therein, and majority stockholders may not use their power to control corporate activities to benefit themselves alone or in a manner detrimental to the minority. The

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the contribution of assets to the operating partnership to make the contribution a taxable exchange if the operating partnership was treated as an investment company. However, the investment company provisions should not be a problem provided that the cash, stock and securities held by the operating partnership are less than 80% of the assets of the operating partnership, based on value.

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court held:

> The rule that has developed in California is a comprehensive rule of "inherent fairness from the viewpoint of the corporation and those interested therein." [citations omitted]. The rule applies alike to officers, directors, and controlling shareholders in the exercise of powers that are theirs by virtue of their position and to transactions wherein controlling shareholders seek to gain an advantage in the sale or transfer or use of their controlling block of shares. *Jones v. Ahmanson & Co., supra,* 1 Cal.3d at p. 110.

The court noted that the potential for oppression by the controlling shareholder may include the reduction or elimination of dividends, citing with approval, Eisenberg, *The Legal Role of Shareholders and Management in Modern Corporate Decision-Making* (1969) 57 Cal. L.Rev.1, 132. (*Jones v. Ahmanson & Co., supra,* 1 Cal.3d at p. 112.)

Directors

Both Delaware and California hold that directors owe fiduciary duties to the corporation and to its shareholders. (See, e.g., *Loft, Inc. v. Guth* (Del. Ch. 1938) 2 A.2d 225, 238; *Bancroft-Whitney Co. v. Glen* (1966) 64 Cal.2d 237, 345; *Small v. Fritz Companies, Inc.* (2003) 30 Cal.4th 167; *Professional Hockey Corp. v. World Hockey Assn.* (1983) 143 Cal. App. 3d 410.)

As is true for controlling shareholders in Delaware, the fiduciary duties provided for under Delaware law for directors include the duty of loyalty and the duty of care. (*Malone v. Brincat* (Del. 1998) 722 A.2d 5, 10.) However, Delaware's General Corporation Law allows corporations to grant their directors certain protections from monetary liability with respect to the duty of care. Section 102, subsection (b)(7) states:

> [T]the certificate of incorporation may also contain . . . [a] provision eliminating of limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director . . . provided that such provision shall not eliminate or limit the liability of a director: (i) for any breach of the director's duty of loyalty to the corporation or its stockholders; (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law; . . . or (iv) for any transaction from which the director derived an improper personal benefit.

In California, waiver of corporate directors' and majority shareholders' fiduciary duties to minority shareholders, at least in private close corporations, has been held to be against public policy, and a contract provision in a buy-sell agreement purporting to effect such a waiver is void. (*Neubauer v.* Goldfarb (2003) 108 Cal. App.4th 47 construing Civ. Code, § 1668.) Certain limitations on the duties of directors may, however, be permitted to limit monetary damages. (See Cal. Corp. Code, § 204.) In addition, statutes in both California and Delaware provide a safe harbor for contracts with directors under certain circumstances. [4]

As in Delaware, it has been held in California that the fiduciary duties of directors include the duty of care and the duty of loyalty. (*Frances T. v. Village Green Owners Association, et al.* (1986) 42 Cal.3d 490, 513; *Trans-World International, Inc. v. Smith-Hemion Productions Inc.* (C.D. Cal. 1997) 972 F.Supp. 1275.) The duties are reflected in Corporations Code section 309, subdivision (a) which provides,

> A director shall perform the duties of a director, including duties as a member of any committee of the board upon which the director may serve, in good faith, in a manner such director believes to be in the best interests of the corporation and its shareholders and with such care, including reasonable inquiry, as an ordinarily prudent person in a like position would use under similar circumstances.

Some authorities also make reference to a duty of good faith. Good faith is arguably an obligation separate from the fiduciary duties of care and loyalty. Good faith is presumed and the party challenging it has the burden of rebutting that presumption. (*Citron v. Fairchild Camera & Instrument Corp.* (D.Del. 1989) 569 A.2d 53, 64.) There has been case law in Delaware suggesting that the obligation of good faith is identical to the duty of loyalty. (*Continuing Creditors' Committee of Star Telecommunications Inc. v. Edgecomb* (D.Del. 2004) 385 F.Supp.2d 449, 460, n.9; see also *Nagy v. Bistricer,* (Del. Ch. 2000) 770 A.2d 43, 49, n.2.) However, the Supreme Court of Delaware in its recent decision, *In re The Walt Disney Company Derivative Litigation*, held that good faith and the duty of care are in fact legally distinct. The court stated:

The conduct that is the subject of due care may overlap with the conduct that comes within the rubric of good faith in a psychological sense, but from a legal standpoint those duties are and must remain quite distinct. Both our legislative history and our common law jurisprudence distinguish sharply between the duties to exercise due care and to act in good faith, and highly significant consequences flow from that distinction.

The Delaware General Assembly has addressed the distinction between bad faith and a failure to exercise due care (*i.e.,* gross negligence) in two separate contexts. The first is Section 102(b)(7) of the DGCL, which authorizes Delaware corporations, by a provision in the certificate of incorporation, to exculpate their directors from monetary damage liability for a breach of the duty of care.

That exculpatory provision affords significant protection to directors of Delaware corporations. The statute carves out several exceptions, however, including most relevantly, "for acts or omissions not in good faith...." Thus, a corporation can exculpate its directors from monetary liability for a breach of the duty of care, but not for conduct that is not in good faith. To adopt a definition of bad faith that would cause a violation of the duty of care automatically to become an act or omission "not in good faith," would eviscerate the protections accorded to directors by the General Assembly's adoption of Section 102(b)(7).

A second legislative recognition of the distinction between fiduciary conduct that is grossly negligent and conduct that is not in good faith, is Delaware's indemnification statute, found at 8 *Del. C.* § 145. To oversimplify, subsections (a) and (b) of that statute permit a corporation to indemnify *(inter alia)* any person who is or was a director, officer, employee or agent of the corporation against expenses (including attorneys' fees), judgments, fines and amounts paid in settlement of specified actions, suits or proceedings, where (among other things): (i) that person is, was, or is threatened to be made a party to that action, suit or proceeding, and (ii) that person "acted in good faith and in a manner the person reasonably believed to be in or not opposed to the best interests of the corporation . . . . (*In re The Walt Disney Company Derivative Litigation* (Del. Sup. 2006) Westlaw 1562466 at *25-26. (footnotes omitted) (unpublished opinion).)

The Supreme Court of Delaware issued its decision (unpublished as of the time of the preparation of this article) on June 8, 2006. In that case, the plaintiffs asserted, among other things, that the Disney directors breached their fiduciary duty with respect to the hiring and termination of Michael Ovitz, including a severance payout of $130 million. The Delaware Supreme Court affirmed the Chancery Court's decision after trial that the Disney defendants did not breach their fiduciary duty. The decision is notable, among other things, for providing guidance as to what constitutes good faith for directors. The court explained:

> This case … is one in which the duty to act in good faith has played a prominent role, yet to date is not a well-developed area of our corporate fiduciary law. Although the good faith concept has recently been the subject of considerable scholarly writing, which includes articles focused on this specific case, the duty to act in good faith is, up to this point relatively uncharted. Because of the increased recognition of the importance of good faith, some conceptual guidance to the corporate community may be helpful. (*Id.* at *24.)

The court then went on to identify at least three different categories of fiduciary behavior as candidates for the bad faith label. These were: (1) subjective bad faith, referring to conduct motivated by an intent to do harm; (2) grossly negligent actions taken without malevolent intent; and (3) intentional dereliction of duty or a conscious disregard of one's responsibilities.

Under Delaware law, self-dealing transactions for directors (*i.e.*, where the director is effectively on both sides of the transaction) are subject to the entire fairness test. (See *Weinberger v. UOP, Inc.* (D.Del. 1983) 457 A.2d 701703. In *Technicorp International II, Inc. v. H. Johnston* (Del. Ch. 2000) Westlaw 713750, the Delaware Chancery Court explained:

> Corporate officers and directors, like all fiduciaries, have the burden of showing that they dealt properly with corporate funds and other assets entrusted to their care, Where, as here, fiduciaries exercised exclusive power to control the disposition of corporate funds and their exercise in challenged by a beneficiary, the fiduciaries have a duty to account for their disposition of those funds, i.e. to establish the purpose, amount and property of the disbursements. And where, as here, the fiduciaries cause those funds to be used for self-interested purposes, i.e., to be paid to themselves or to others for the fiduciary's benefit, they have the 'burden of establishing [the transactions'] entire fairness, sufficient to pass the test of careful scrutiny by the court. (*Id.* at p. 16.)

As a practical matter, in a claim by the corporation either directly, or, more commonly, in a derivative action, the application of the entire fairness test is likely to be crucial to success of a claim by a plaintiff. The alternative is the application of the business judgment rule. The business judgment rule embodies the deference that is accorded to managerial decisions of the board. The United States Court of Appeals in reviewing an action brought by the trustee for a Chapter 7 estate of a debtor-airline to recover from the debtor's former officers and director for their alleged breach of fiduciary duties, described the difficult of overcoming the presumption of the business judgment rule on the merits as "a near-Herculean task," requiring a showing either of irrationality or inattention. (*In re Tower Air, Inc.* (3d Cir. 2005) 416 F.3d 229, 238.)

The business judgment rule reflects a presumption that absent a breach of the fiduciary duties of care and loyalty, or a failure to act in good faith, directors act on an informed basis in the best interest of the corporation. If it is shown that a director breached the fiduciary duties of care or loyalty or did not act in good faith, the burden shifts to that director to demonstrate that the transaction or act at issue satisfies the entire fairness test.

The argument that alleged breaches of fiduciary duty by the Disney directors were subject to the entire fairness test rather than the presumptions provided by the business judgment rule was a central position asserted by the plaintiffs in that case.

The Delaware courts will under certain circumstances subject director's action to enhanced judicial scrutiny before the presumptive protection of the business judgment rule can be invoked. (*Omnicare, Inc. v. NCS Healthcare, Inc.* (D.Del. 2003) 818 A. 2d. 914, 928.) These circumstances will most commonly arise when directors are often confronted with an "'inherent conflict of interest' such as contests for corporate control '[b]ecause of the omnipresent specter that a board may be acting primarily in its own interests, rather than those of the corporation and its shareholders.'" (*Unocal Corp. v. Mesa Petroleum Co.* (Del. 1985) 493 A.2d 946, 954.) Consequently, during contests for corporate control, under Delaware law directors have to satisfy the additional burden of enhanced judicial scrutiny before they are accorded the deference of the business judgment rule. Enhanced scrutiny consists of a two part test: (1) a *reasonableness test,* which is satisfied by a demonstration that the board of directors had reasonable grounds for believing that a danger to corporate policy and effectiveness existed; and (2) a *proportionality test,* which is satisfied by a demonstration that the board of directors' defensive response was reasonable in relation to the threat posed. Only if the directors are able to satisfy that burden are their actions accorded the deferential business judgment rule. (*Unitrin, Inc. v. American General Corp.,* (Del. 1995) 651 A.2d 1361, 1373.) If the directors are not able to satisfy that burden (or if the presumption of the business judgment rule is defeated for any other reason), the more critical entire fairness standard applies instead. (*Grobow v. Perot,* (Del. Sup. 1988) 539 A.2d 180, 187 (citing *Aronson v. Lewis* (1984 Del. Sup.) 473 A.2d 805, 812-17.). This standard requires judicial scrutiny of both "fair dealing" and "fair price." (*Unitrin, Inc. v. American General Corp., supra,* 651 A.2d at p. 1373.)

In *Paramount Communications, Inc. v. QVC Network, Inc.,* the court identified the key feature of enhanced judicial scrutiny as a "judicial determination regarding the adequacy of the decision making process employed by the directors, including the information on which the directors based their decision." (*Paramount Communications, Inc. v. QVC Network, Inc., supra,* 637 A.2d at p. 45.) The second feature of enhanced judicial scrutiny is, "a judicial examination of the reasonableness of the directors' action in light on the circumstances then existing." (*Omnicare, Inc. v. NCS Healthcare, Inc., supra,* 818 A.2d at p. 930, quoting *Paramount Communications, Inc. v. QVC Network, Inc., supra,* 637 A.2d at p. 45.) Under this standard, directors are permitted some latitude. The director's action needs only be in the range of reasonableness. (*Unitrin, Inc. v. Am. Gen. Corp., supra,* 651 A.2d at 1388., see also, *Unocal Corp. v. Mesa Petroleum Co.,* 493 A,2d 946, 954-57 (D.Del. 1985).)

As is true under Delaware law, California case law has repeatedly stated that directors owe fiduciary duties to their corporations, which at a minimum include a duty of care and a duty of loyalty. Like Delaware courts, California courts at least claim that they afford directors the benefit of the business judgment rule,[5] which provides a presumption the directors' decision are based on sound judgment. (*Gaillard v. Natomas Company* (1989) 208 Cal. App.3d1250, 1269.) Notably, in *Guillard,* the Court of Appeals, however, reversed a grant of summary judgment in favor of the outside directors by holding that it was a jury issue as to whether these directors exercised due care.

The Delaware courts' use of "enhanced judicial scrutiny" of directors in certain instances before determining whether to apply the business judgment rule is not frequently seen in California case law. It is not, however, entirely absent in California. (See, e.g., *Mueller v. Macban* (1976) 62 Cal.App.3d 258,274 discussing circumstances involving "rigorous scrutiny" with respect to directors and controlling shareholders.) The widespread use of the concept in Delaware decisions suggests that a similar argument in an appropriate California case might prove successful.

The director's duty of care in California is codified in Corporations Code section 309, which states:

(a) A director shall perform the duties of a director, including duties as a member of any committee of the board upon which the director may serve, in good faith, in a manner such director believes to be in the best interests of the corporation and its shareholders and with such care, including reasonable inquiry, as an ordinarily prudent person in a like position would use under similar circumstances.

(b) In performing the duties of a director, a director shall be entitled to rely on information, opinions, reports or statements, including financial statements and other financial data, in each case prepared or presented by any of the following:

(1) One or more officers or employees of the corporation whom the director believes to be reliable and competent in the matters presented. (2) Counsel, independent accountants or other persons as to matters which the director believes to be within such person's professional or expert competence. (3) A committee of the board upon which the director does not serve, as to matters within its designated authority, which committee the director believes to merit confidence,

so long as, in any such case, the director acts in good faith, after reasonable inquiry when the need therefore is indicated by the circumstances and without knowledge that would cause such reliance to be unwarranted. (c) A person who performs the duties of a director in accordance with subdivisions (a) and (b) shall have no liability based upon any alleged failure to discharge the person's obligations as a director. In addition, the liability of a director for monetary damages may be eliminated or limited in a corporation's articles to the extent provided in paragraph (10) of subdivision (a) of Section 204.

Under Delaware law, a director of a corporation which in turn is a general partner of a partnership may also owe a fiduciary duty not only to the corporation, but to the partners of the partnership. In *Gelfman v. Weeden Investors, L.P.* (D.Del. 2001) 792 A.2d 977, limited partners in a broker-dealer business brought an action against the broker-dealer's corporate general partner and members of that general partner's board and top management for breach of fiduciary duty. In a footnote, the Chancery Court explained:

I disagree with the defendants' argument that the individual defendants must be dismissed from the suit. Their argument in this regard raises yet again the awkward position occupied by directors of corporate General Partners. *See Gotham Partners, L.P. v. Hallwood Realty Partners, L.P.*, Del.Ch., C.A. No. 15754, 2000 WL 1476663, at *20, Strine, V.C. (Sept. 27, 2000) (discussing some of the anomalies raised by this issue). Do they owe fiduciary duties to limited partners akin to those owed by corporate directors to stockholders, even though it is the corporate general partner which is the core fiduciary? Prior cases have held that the answer is yes where directors of a corporate general partner have acted in a way that is potentially advantageous to their personal interests and at the expense of the limited partners. *See In re USACafes, L.P. Litig.*, Del.Ch., 600 A.2d 43 (1991); *Wallace v. Wood*, Del.Ch., 752 A.2d 1175, 1180 (1999); *In re Boston Celtics Limited Partnership Shareholders Litig.*, C.A. No. 16511, 1999 WL 641902, at *4, Steele, V.C. (Aug. 6, 1999). In this case, the named defendants are directors and/or officers of the General Partner, each of whom is alleged to have a substantial ownership in the Partnership. It is inferable from the complaint that by way of the actions challenged in the complaint each of the individual defendants increased his proportionate ownership in the Partnership at the expense of Outside Investors. While it is generally true that non-parties to a contract may not bear contractual liabilities, our limited partnership case law recognizes that a director of a corporate general partner may still bear fiduciary liability if the director's conduct causes the corporate general partner to breach a modified fiduciary or substitute contractual duty to the limited partners. *See Gotham Partners v. Hallwood Realty Partners, L.P.*, Del.Ch., C.A. No. 15754, mem. op. at 75-77, 2001 WL 1823944, Strine, V.C. (July 18, 2001, corr. Aug. 1, 2001). In this respect, the director's ability to disclaim liability for breach of fiduciary duty depends on whether the corporate general partner he helps control has properly invoked a contractual safe harbor. (*Id.* at n. 24.)

Also, under Delaware law, in some circumstances a director may owe a fiduciary duty not only to the corporation but also effectively to its creditors. Typically, Delaware law does not permit creditors to allege fiduciary duty violations against corporate directors. The Delaware courts reason that creditors have the protection of other legal tools, such as contract claims, the law of fraudulent conveyance, and federal bankruptcy law. (*Production Resources v. NCT Group* (Del. 2004) 863 A.2d 772, 787.) However, when a corporation becomes insolvent, its creditors take on the same role as the corporation's shareholders: they become residual risk bearers. (*Id.* at p. 791.) The possibility of insolvency exposes creditors to risks of opportunistic behavior. (*Credit Lyonnaise Bank v. Pathe Communications* (Del. Ch. 1992) Lexis 215 at 108 (unpublished opinion).) Thus, insolvency "creates fiduciary duties for directors for the benefit of the creditors." (*Geyer v. Ingersoll Publications Co.* (Del. Ch. 1992) 621 A.2d 784, 787.) Creditors are deemed to have an equity interest in an insolvent corporation's assets, and the directors of the insolvent corporation have a fiduciary duty to preserve capital for the benefit of the creditors. (*Production Resources v. NCT Group, supra,* 863 A.2d at p. 791.) The application of fiduciary duties may apply to creditor relationship even before actual bankruptcy, if the corporation is in the "vicinity" of insolvency.

California also recognizes this duty to creditors. (See *Commons v. Schine* (1973) 35 Cal.App.3d 141, 144 "The corporate controller-dominator is treated in the same manner as a director of an insolvent corporation and thus occupies a fiduciary relationship to its creditors".) California state and bankruptcy courts cite to the United States Supreme Court's decision in *Pepper v. Litton* for the proposition that a director of an insolvent corporation is a fiduciary whose obligation extends to creditors. (See, e.g., *Nahman v. Jacks (In re Paul)* (2001) 266 B.R. 728, 736, citing *Pepper v. Litton* (1939) 308 U.S. 295, 307, (Standard of fiduciary obligation is designed for the protection of the entire community of interests in the corporation—creditors as well as stockholders); see also *Commons v. Schine, supra,* 35 Cal.App.3d at p. 144 .)[6]

Officers

Under both California law and Delaware law a corporate officer with management powers is a fiduciary of a corporation. (See, e.g., *Stephenson v. Drever* (1997) 16 Cal.4th 1167; *United States Liab. Ins. Co. v. Haidinger-Hayes, Inc.* (1970) 1 Cal.3d 586; *GAB Bus. Serv. Inc. v. Lindsey & Newsom Claim Servs., Inc.* (2000) 83 Cal.App.4th 409 disapproved on another point in *Reeves v. Hanlon* (2004) 33 Cal.4th 1140.)

In California, a nominal corporate officer with no management authority has been held not to be a fiduciary of the corporation. (*GAB Business Services, Inc. v. Lindsey & Newsom Claim Services, Inc.* (2000) 83 Cal.App.4th 409 as modified, (Sept. 14, 2000) and as modified on denial of reh'g, (Sept. 26, 2000).)

Employees

The law concerning the status of employees who are not officers (whether in title or in fact) as fiduciaries is relatively sparse. However, commentators have concluded that in California, "employees who are not officers or directors are generally not considered to be fiduciaries and thus owe no fiduciary duty to their employers." (Chin et al., Cal. Prac. Guide: Employment Litigation (The Rutter Group 2005) 14:33.) California case law supports this conclusion. (See, e.g., *Calvao v. Sup. Ct. (Klippert)* (1988) 201 Cal.App.3d 921, 923 ("The superior court in its trial de novo believed there was a fiduciary relationship between the county and its employees. . . . However, this is an employment contract situation. There is no confidential or fiduciary relationship in this context."); *O'Byrne v. Santa Monica-UCLA Medical Center* (2001) 94 Cal.App.4th 797, 811-812 ("[E]mployment-type relationships are not fiduciary relationships. In the absence of a fiduciary relationship, there can be no breach of fiduciary duty as a matter of law."); *Wiltsee v. California Employment Commission* (1945) 69 Cal.App.2d 120, 128-29 (Employer-employee relationship, that even included a 25% profit interest, was insufficient to create a fiduciary relationship between the parties).)

These decisions in California stand in contrast to the broad language concerning fiduciary duties of employees which may be found in other jurisdictions. (See, e.g., *Eckard Brandes, Inc. v. Riley* (9th Cir. 2003) 338 F.3d 1082 (holding that regular employees owe their corporate employer a fiduciary duty in Hawaii).)

Notwithstanding the foregoing broad statements concerning the lack of a fiduciary status for ordinary employees in California, in particularly instances it may be appropriate to find a limited fiduciary relationship between an ordinary employee and his corporate employer. Similarly, in Delaware, there is case law referring to a fiduciary duty of employees in certain contexts. (See, e.g., *Science Accessories Corp. v. Summagraphics Corp*. (1980) 425 A.2d 957, 961.)

Promoters

In the context of corporations, California also recognizes that in certain circumstances even promoters, although they are not directors, officers, or controlling shareholders, have fiduciary duties. Typically these cases arise where the promoter has obtained a secret undisclosed profit. Delaware has also recognized fiduciary duties in promoter cases.

Conclusion

While attention has properly been focused on the duties of directors under the Sarbanes-Oxley Act and other federal securities and criminal laws, state law in both Delaware and California continues to provide ample authority for regulating the conduct not only of officers and directors of corporations, but also corporate promoters, controlling shareholders, and employees. ■

Endnotes

[1] The author wishes to gratefully acknowledge the assistance of Olga Kuskova in the preparation of this article.

[2] See, e.g., Ribstein, *Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002* (2002) 28 Iowa J.Corp.L. 1; Chandler & Strine, *The New Federalism# of the American Corporate Governance System: Preliminary Reflections of Two Residents of One Small State* (2003) 152 U. Pa. L.Rev. 953, 957; Brown, *The Irrelevance of State Corporate Law in the Governance of Public Companies* (2004) 38 U.Rich. L.Rev. 317, 319-20; Roe, *Delaware's Competition* (2003) 117 Harv. L.Rev. 588. Practising Law Institute PLI Order No. (8423 May 2006) *What All Business Lawyers & Litigators Must Know About Delaware Law Developments 2006 Federalism vs. Federalization Preserving the Division of Responsibility in Corporation Law,* December 28, 2005 The Honorable E. Norman Veasey Weil, Gotshal & Manges, LLP, Shawn Pompian, Attorney Advisor Office of the Legal Advisor, United States Department of State, Christine DiGuglielmo, Weil Gotschal & Manges, LLP.

[3] Depending upon the circumstances, there may also be a difference in applicable law turning on whether or not the corporation is a statutory close corporation. (See *Nixon v. Blackwell* (Del. 1993) 626 A.2d 1366.)

[4] See Corp. Code, § 310 and 8 Del. Code Ann., § 144.

[5] Some commentators have suggested that a distinction be made between a "business judgment rule" which would immunize directors from liability and a "business judgment doctrine." (See, e.g., Hinsey, *Business Judgment and the American Law Institute's Corporate Governance Project: The Rule, the Doctrine and the Reality* (1984) 52 Geo. Wash. L.Rev. 609, 611-12 ("Courts and commentators have generally overlooked the distinction between the business judgment rule and the business judgment doctrine. . . . This has resulted in unfortunate misunderstanding and confusion. The business judgment rule shields individual directors from liability for damages stemming from decisions, whereas the business judgment doctrine protects the decision itself.")

[6] Some jurisdictions have adopted "other constituency" statutes that provide for fiduciary duties for directors to constituencies including employees, customers, suppliers, and local communities.

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software, and other security measures way beyond the scope of this article. Suffice it to say this is a fear that can easily override the benefits listed above. For some companies, the cost of putting appropriate security measures in place would wipe out any costs savings inherent in telecommuting. However, this is usually not the case, and more and more companies are marketing "turnkey" secure telecommuting solutions for both large and small businesses.

Ultimately, the success or failure of a telecommuting program will depend on whether the telecommuters are getting their work done. This will, in turn, depend on three factors: the choice of positions that are eligible for telecommuting, the choice of telecommuting employees, and the skill of the managers in managing remote employees.

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The main reason that HP removed a number of IT positions from its "eligible for telecommuting" list was because a push for IT development required intensive coordination among employees. The need for coordination, even in an IT environment, argues against full-time telecommuting. Alternatively, research, analysis, report writing, and telephone-intensive tasks are usually good candidates for telecommuting positions.

Obviously, employees who are in constant need of supervision should not be permitted to telecommute. And managers need to develop strong reporting and review standards so that work doesn't get off course.

However, the fear that employees will goof off if not constantly watched has proven to be ill-founded. Companies and governmental agencies report significant increases in productivity. Examples include Maryland Department of Transportation's 27% increase in productivity and JD Edwards' 20-25%. American Express reported a whopping 43%; and Dow Chemical reported a 32.5% increase, broken down as 10% through decreased absenteeism, 6.5% due to avoiding commute related problems, and 16% due to being able to work at home.

An infrequent, but vexing problem for interstate telecommuting employees is the possibility of being taxed in both their employer's state and their own. Legislation is pending in Congress to prohibit double taxation.