Corporate Fiduciary Duties in Kentucky

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Corporate Fiduciary Duties in Kentucky

BY RUTHEFORD B CAMPBELL, JR.*

This article is dedicated to the memory of Professor Willburt D. Ham. The article is also a belated offering of thanks to Burt for his decades of teaching, writing, and law reform activities. No one contributed more to the orderly and sensible development of business and corporate law in Kentucky than Burt Ham.

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I. INTRODUCTION

Since the beginning of the 1980s, corporate fiduciary law has exploded. Delaware courts have handled a large number of important cases and their opinions have had a dramatic impact on the jurisprudence of corporate fiduciary duties. Seminal cases, such as Van Gorkom, Weinberger, and Revlon, have changed the way we think about corporate fiduciary duties.

Somewhat less apparent in its impact, but nonetheless important, has been the force of the law and economics movement. As concerns corporate fiduciary duties, law and economics scholars argue that, ideally, corporate owners (shareholders) and their agents (corporate managers) should be left free to fashion their own fiduciary duties without any intrusion from the state in the form of state-mandated rules regarding corporate fiduciary duties. Economic efficiency, they argue with considerable force, is most readily achieved by letting owners and their agents pursue and price their own preferences regarding the nature and extent of the obligations that the agents owe to the owners. These scholars concede, however, that bargaining between corporate owners and their agents is typically either impossible or prohibitively expensive. The standard approach of law and economics scholars to such bargaining impossibility is to propose that states ought to enact default fiduciary duty rules similar to the rules that the parties (i.e., the owners and their agents) would use if they were able to bargain with one another.

1 Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985). These cases will be described infra.
4 The literature of the law and economics movement is enormous. For a sampling of the literature generally, and its application to the matter of corporate fiduciary duties, see Rutheford B Campbell, Corporate Fiduciary Principles for the Post–Contractarian Era, 23 FLA. ST. U. L. REV. 561, 561–67 & nn. 2–29 (1996) [hereinafter Campbell, Corporate Fiduciary Principles].
5 See id. at 565.
6 It is hard to argue against the idea that parties, in this case owners and managers, should be free to construct the terms of their own arrangement when, as seems to be the case, there are no significant externalities or third–party effects to the contract. See, e.g., Frank H. Easterbrook & Daniel R. Fischel, The Corporate Contract, 89 COLUM. L. REV. 1416, 1428 (1989) (“Just as there is no right amount of paint in a car, there is no right relation among managers, investors, and other corporate participants.”).
7 See, e.g., Richard A. Posner, The Ethical and Political Basis of the Efficiency Norm in Common Law Adjudication, 8 HOFSTRA L. REV. 487, 494 (1980) (explaining that we can infer consent “by trying to answer the hypothetical question whether, if transaction costs were zero, the affected parties would have agreed to the institution”); Daniel R. Fischel, The Corporate Governance Movement, 35 VAND. L. REV. 1259, 1264 (1982) (“Optimal fiduciary
In this article I offer an interpretation of Kentucky's corporate fiduciary law. The article is positive, in that it attempts to explain our law by reference to certain principles. The article is also normative, however, in that it offers constructive criticism regarding parts of Kentucky fiduciary law and suggests changes, refinements, and clarifications intended to promote fairness and economic efficiency in Kentucky corporations.

Both the positive and the normative aspects of this piece recognize the importance of the common law developments in Delaware (and other states) and the importance of the law and economics movement. I suggest, however, that Kentucky should be selective in the weight it accords to Delaware jurisprudence. Delaware cases are unfortunately too often confusing, contradictory, and needlessly complex, and thus they can slow or, indeed, actually misdirect an orderly development of the common law of corporate fiduciary duties.

Section II of this article discusses the most fundamental issue in corporate fiduciary law: the identity of the beneficiary of management’s fiduciary obligation. Stating the issue more precisely, to whom or to which corporate constituency does the management of a Kentucky corporation owe its fiduciary duty?

Section III offers a broad construct for fiduciary duty obligations. It shows that courts—including Kentucky courts—vary the substantive standards by which they judge the propriety of managers’ conduct. The applicable standard depends in the first instance on whether management is engaged in its monitoring function or is making a discrete decision. In discrete decisions, the standard changes depending on the existence and depth of any conflict in which managers may find themselves. This construct—separating duties in terms of monitoring versus discrete decisions, and in terms of the existence and depth of conflict—provides a sensible and manageable approach to fiduciary duty problems, even though the broad analysis is infected to a degree by a few poorly reasoned and articulated court opinions.

Finally, Section IV discusses a number of specific issues and transactions that are important in Kentucky fiduciary law. I offer suggestions of the ways in which Kentucky courts can, in dealing with the issues or transactions, ensure outcomes that are fair and economically efficient.

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duties should approximate the bargain that investors and managers would reach if transaction costs were zero."}
II. THE OBLIGATION TO ACT IN THE BEST INTERESTS OF SHAREHOLDERS

A. The Law Generally

The question of the identity of the beneficiaries of corporate managers' fiduciary duties has been around for decades.\(^8\) Usually legal scholars have debated this as a normative issue, arguing about whether fiduciary duties should be expanded to protect, in addition to shareholders of the corporation, other important corporate constituencies, such as creditors\(^9\) or employees.\(^10\) Not surprisingly, this debate intensified in the wake of the acquisitions of the 1980s, when nonshareholder constituencies, most apparently creditors, suffered tremendous losses as a result of highly

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leveraged acquisitions and, in some cases, the business failures that followed.11

On the positive side of this question, the traditional view is that corporate fiduciaries owe an obligation to act in the best interests of the shareholders of the corporation.12 Some scholars, however, disagree with this traditional position and argue that, as a positive matter, today's corporate fiduciary law does not require corporate managers, principally directors, to pursue solely the best interests of shareholders.13 Under this line of scholarship, directors have the right to act in the best interests of nonshareholder constituencies, even when such actions are harmful to shareholder interests. Boldly it is stated that the "corporate law . . . generally allows directors to redirect wealth from shareholders to other stakeholders."14 In support of this position these scholars cite, for example, the right of corporate boards to make charitable contributions, language from takeover cases that permit target boards to consider the interests of other constituencies in corporate acquisitions, and constituency statutes,15 all of which in their minds show that directors are permitted to take actions that transfer corporate wealth from shareholders to other constituencies and thus they are not obliged to pursue wealth maximization on behalf of shareholders.

As a positive matter, I side with traditional scholars and conclude that generally corporate managers are obliged by current legal rules to act in the

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11 See, e.g., Hurst & McGuinness, supra note 9, at 190 n.14 (noting that since 1984, 230 companies have been involved in transactions that resulted in downgrades of their credit rating); Marcel Kahan & Michael Klausner, Antitakeover Provisions in Bonds: Bondholder Protection or Management Entrenchment?, 40 UCLA L. Rev. 931, 933 & n.2 (1993) ("From 1984 through 1988, the bonds of 183 companies . . . lost value as a result of mergers, acquisitions, or leveraged buyouts."); McDaniel, Bondholders and Stockholders, supra note 9, at 206 (characterizing losses to bondholders during this period as "possibly the largest expropriation of investors in American business history").


14 Stout, supra note 8, at 1203. At another point in her piece, Professor Stout states even more strongly that "Delaware gives directors free rein to pursue strategies that reduce shareholder wealth while benefitting other constituencies." Id. at 1202.

15 See Blair & Stout, supra note 13, at 285; Stout, supra note 8, at 1201–1207.
CORPORATE FIDUCIARY DUTIES

best interests of shareholders. This seems to be the view most prevalent among scholars, and is also supported by cases and commentary.

There are and always have been, however, certain carve-outs from a ubiquitous obligation to act in the best interests of shareholders. These carve-outs are subject to a "reasonableness" limitation. Thus, even in instances in which corporate fiduciaries are permitted to take actions that are contrary to the best interests of shareholders, the extent of shareholder wealth transferred to a nonshareholder constituency cannot be unreasonable in amount. The classic example of such a carve-out is the generally

16 In a prior article, I offered a positive analysis of corporate fiduciary law based roughly on Pareto criteria. See Rutherford B Campbell, Jr., A Positive Analysis of the Common Law of Corporate Fiduciary Duties, 84 KY. L.J. 455, 456-73 (1996). Under this analysis corporate fiduciaries are obliged to make any move that makes at least one shareholder better off and no shareholder worse off. Corporate fiduciaries are prohibited from making any move that creates a loser within the shareholder constituency.

17 See supra note 11; see also Stephen M. Bainbridge, Director v. Shareholder Primacy in the Convergence Debate, 16 TRANSNAT'L LAW. 45, 48 (2003) ("Despite occasional academic arguments to the contrary, the shareholder wealth maximization norm . . . indisputably is the law of the United States.").

18 See, e.g., Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 182 (Del. 1985); Dodge v. Ford Motor Co., 170 N.W. 668, 684 (Mich. 1919) ("A business corporation is organized and carried on primarily for the profit of stockholders. The powers of directors are to be employed for that end."). See also the Kentucky cases cited at notes 34–38, infra, which do not amount to holdings but clearly indicate that Kentucky courts view the obligation of managers to act in the best interests of shareholders. In addition, landmark cases, such as Smith v. Van Gorkom, 488 A.2d. 858, 872 (Del. 1985) (holding that directors breached fiduciary duties because they did not exercise due care in pursuit of shareholder wealth maximization), and Weinberger v. UOP, Inc., 457 A.2d 701, 703 (Del. 1983) (holding that directors breached fiduciary duties because they did not exercise fair dealing in protection of the interests of minority shareholders), are consistent with the obligation to act in the best interests of shareholders.

19 See PRINCIPLES OF CORP. GOVERNANCE § 2.01(a) (1992) ("[A] corporation should have as its objective the conduct of business activities with a view to enhancing corporate profit and shareholder gain.").

20 It may be, therefore, that my disagreement with the new scholarship described above, which interprets today's corporate law as permitting directors to reallocate corporate wealth away from shareholders to other constituencies, see supra notes 12–14, is only a matter of degree. I concede that directors can make such reallocations, but my view is that the
recognized right of a board to authorize a "reasonable" amount of charitable contributions by its corporation,\textsuperscript{21} even though the contributions do not enhance shareholder wealth.\textsuperscript{22}

Constituency statutes\textsuperscript{23} represent another such carve-out. These statutes expressly permit directors to consider the interests of nonshareholder corporate constituencies\textsuperscript{24} and have received the most attention regarding defensive actions taken by directors in connection with hostile acquisitions.

\begin{itemize}
\item[21] The median level of corporate contributions has normally been around 1% of pretax income.\textsuperscript{22} MELVIN ARON EISENBERG, CORPORATIONS AND OTHER BUSINESS ORGANIZATIONS: CASES AND MATERIALS 147 (8th ed. 2000) (citing a study by The Conference Board).
\item[22] In A.P. Smith Mfg. Co. v. Barlow, 98 A.2d 581, appeal dismissed, 346 U.S. 861 (1953), the New Jersey court stated in affirming the propriety of a corporate gift to Princeton University that the gift was made to a preeminent institution of higher learning, was modest in amount and well within the limitations imposed by the statutory enactments, and was voluntarily made in the reasonable belief that it would aid the public welfare and advance the interests of the plaintiff as a private corporation and as part of the community in which it operates. We find that it was a lawful exercise of the corporation's implied and incidental powers under common-law principles and that it came within the express authority of the pertinent state legislation. . . . Corporations . . . with their enlightenment have sought in varying measures . . . to insure and strengthen the society which gives them existence and the means of aiding themselves and their fellow citizens. Clearly then, the appellants, as individual stockholders whose private interests rest entirely upon the well-being of the plaintiff corporation, ought not be permitted to close their eyes to present-day realities and thwart the long-visioned corporate action in recognizing and voluntarily discharging its high obligations as a constituent of our modern social structure.\textsuperscript{24}
\item[23] Id. at 590.
\item[24] A distinguished corporate commentator stated: "Donations should be reasonable in amount in light of the corporation's financial condition . . . . Direct corporate benefit is no longer necessary but corporate interest remains as a motive." Ray Garrett, Corporate Donations, 22 Bus. Law. 297, 301 (1967).
\item[25] See, e.g., IND. CODE ANN. § 23-1-35-1 (West 2004); N.Y. BUS. CORP. LAW § 717 (McKinney 2004). Neither the Indiana provision nor the New York provision, however, is limited to acquisition situations.
\end{itemize}
The right granted under these statutes for directors “to consider . . . the effects” that their actions may have on other constituencies, however, similar to the right to make charitable contributions, must be limited by a reasonableness standard. One would not, therefore, anticipate that any court would allow a board to facilitate an acquisition that protected the value of creditors’ debt instruments or the jobs of employees but paid shareholders only $1 per share, when a competing bidder for the company was willing to pay shareholders $100 per share for their common stock.

Finally, one should similarly interpret the language from some Delaware cases that suggests directors can favor the interests of non-shareholder constituencies over that of shareholders. In what is perhaps the most dramatic example of this, the Supreme Court of Delaware stated in Paramount Communications v. Time, Inc., that “a board of directors . . . is not under any per se duty to maximize shareholder value.” At least one noted commentator has correctly pointed out, however, that each of the Delaware cases cited immediately above contains language suggesting that directors owe an obligation to promote the best interests of shareholders. But in all events, to the extent one reads the quoted passages as permitting directors to favor the interests of nonshareholder constituencies at the expense of shareholder interests, that should once again be considered a carve-out from the overarching obligation of managers to act in the best interests of shareholders and thus it is subject to a quantitative reasonableness limitation.

Two examples from the Principles of Corporate Governance best demonstrate how these carve-outs and the reasonableness limitation operate. In one example, a company with $100 million in assets and

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26 See, e.g., Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 955 (Del. 1985) (stating that directors, in choosing a course of action, may consider “the impact on ‘constituencies’ other than shareholders (i.e., creditors, customers, employees, and perhaps even the community generally)”).
28 See Eisenberg, supra note 21, at 148–49. With regard to Unocal, see supra note 26 and accompanying text. Professor Eisenberg finds that different “passages seem to pull in opposite directions” on the matter. See Eisenberg, supra note 21, at 148. With regard to Paramount, Professor Eisenberg finds language from the case that “seems to focus on a threat to shareholder’s interests.” Id. at 149.
29 Delaware does not have a constituency statute. These opinions, therefore, may be viewed as creating a common law constituency statute.
30 PRINCIPLES OF CORP. GOVERNANCE § 2.01 illus. 19 & 20 (1992).
31 The Principles of Corporate Governance states that “a corporation should have as its objective the conduct of business activities with a view to enhancing corporate profit and shareholder gain.” Id. § 2.01(a). Subsection (b) continues by describing certain limited carve-outs to that broad principle:
earnings of $13 to $15 million annually has a division that is losing $4 million annually and proposes to continue to run the division indefinitely (as opposed to selling it), solely because the anticipated buyer intends to slash the work force. The conclusion in the example is that continuing to run the division cannot be justified because "the expenditures involved are unreasonable in amount in relation to earnings."\(^3\) Shifting the facts for the next example, the assumption is that the company will continue to operate the plant only for three months, which will limit the loss to $500,000, "so as to provide the employees at the plant a period of adjustment prior to its closing." This more modest transfer payment to employees, the illustration concludes, is justified.\(^3\)

**B. Kentucky Law**

1. **Kentucky Law Generally**

One should expect Kentucky to follow the traditional approach on this matter, defining managers' fiduciary duties by reference to the best interests of the company's shareholders while confirming quantitatively reasonable carve-outs of the type described above. Considered as a whole, Kentucky statutes and cases support such a traditional approach.

Kentucky case law offers no significant support for imposing on corporate managers either an obligation or a right to act in the best interests of nonshareholder constituencies at the expense of shareholders. The small amount of language suggesting some such duty to act in the best interests of nonshareholders is from old cases involving bank creditors (i.e., bank depositors) or special circumstances that seem to have no broad application to the matter of corporate managers' duties.\(^3\)

(b) Even if corporate profit and shareholder gain are not thereby enhanced, the corporation, in the conduct of its business:

(2) May take into account ethical considerations that are reasonably regarded as appropriate to the responsible conduct of business; and
(3) May devote a reasonable amount of resources to public welfare, humanitarian, educational, and philanthropic purposes.

\(^{3}\) Id. § 2.01(b).

\(^{32}\) Id. § 2.01 illus. 19.

\(^{33}\) Id. § 2.01 illus. 20.

\(^{34}\) Kentucky has a few very old cases that suggest fiduciary duties are owed by corporate managers to creditors. See, e.g., Caldwell v. Ryan, 190 S.W. 1078, 1080 (Ky. 1917) ("[C]reditors of the bank . . . had the right to seek indemnity from the directors if they were guilty of negligence in the management of the bank . . . .")). These old cases involve fiduciary obligations owed to a special type of creditor: bank depositors. For these reasons,
On the other hand, clear and strong language from numerous Kentucky decisions confirms the obligation on corporate managers to act in the best interests of shareholders. Going back to the early part of the twentieth century and coming forward, one finds language stating that “corporations may be assumed to have been organized solely to make money for their stockholders,” that “a director represents all the stockholders; he is a trustee for them,” and that corporate fiduciaries “owe the duty of exercising diligence and good faith to the minority [shareholders] to obtain the largest amount possible [when selling corporate assets] and to protect their interests.” One also finds other cases consistent with such an obligation, even though the language is less clear.

they should be considered essentially irrelevant to the matter here under discussion.

One also is able to find occasional language suggesting duties to a nonshareholder constituency. For example, in Enterprise Foundry & Machine Works v. Miners Elkhorn Coal Co., 45 S.W.2d 470 (Ky. 1931), the court stated that if directors “misappropriated the funds intrusted to their control, and a creditor was damaged by the act he had a right of action against them for the injury resulting from their illegal conduct.” Id. at 474 (quoting United Soc’y of Shakers v. Underwood, 72 Ky. 609 (9 Bush) (1873)). Such language, however, does not suggest that the duties to creditors assumed by directors are the same fiduciary duties owed to the shareholders of the corporation.

One is required to rely on dicta from Kentucky cases because Kentucky has never decided a case like Revlon in which a management decision facilitated a wealth transfer from shareholders to other constituencies. Instead, the cases usually involve claims by shareholders that managers violated a duty of care or loyalty. See, for example, the description of Lewis & Co. v. Radford, 257 S.W.2d 56, 59 (Ky. 1953), discussed infra at note 39. Courts, in rendering such decisions, are not obligated to decide whether duties are owed only to shareholders.

35 One is required to rely on dicta from Kentucky cases because Kentucky has never decided a case like Revlon in which a management decision facilitated a wealth transfer from shareholders to other constituencies. Instead, the cases usually involve claims by shareholders that managers violated a duty of care or loyalty. See, for example, the description of Lewis & Co. v. Radford, 257 S.W.2d 56, 59 (Ky. 1953), discussed infra at note 39. Courts, in rendering such decisions, are not obligated to decide whether duties are owed only to shareholders.

36 Mfrs.’ Land & Improvement Co. v. Cleary, 89 S.W. 248, 249 (Ky. 1905).

37 Haldeman v. Haldeman, 197 S.W. 376, 381 (Ky. 1917).


39 Lewis, 257 S.W.2d at 56, is an example, albeit one that is somewhat complicated factually. Lewis & Co. owned a minority interest in Radford Company. Mr. Radford was the controlling shareholder and a director of Radford; he also was a director of Lewis & Co. A majority of the Radford Company shareholders, including Lewis & Co., sold their Radford Company stock. Mr. Radford, as a director of Lewis & Co., was alleged to have violated his fiduciary duty in connection with the sale by Lewis & Co. of its Radford Company stock. See id. at 57–58. In the course of the opinion, the court characterized Mr. Radford’s duty as a director of Lewis & Co. as the obligation “to see that the investment was so... disposed of as to bring the most profit to Lewis & Company.” Id. at 59. Such an action would be consistent with the obligation to maximize the value of the Lewis & Co. shareholders. Pursuant to another theory, Lewis & Co. charged that Mr. Radford, as a controlling person and director of Radford Company, owed a fiduciary duty to Lewis & Co. as a minority shareholder. In dealing with these allegations, the court observed that “[n]o act of Radford impaired or decreased in any way... the value of the stock held by Lewis & Company.” Id. Once again, such language supports the notion of an obligation to maximize the value of the stockholders’ interests in their corporation.
This obligation for managers of Kentucky corporations to act in the best interests of shareholders is, similar to the traditional view described above, subject to quantitatively reasonable carve-outs. In Kentucky these carve-outs are principally based on statutes.

The most important of the Kentucky statutes in this regard is Kentucky's constituency statute. It provides that a board, in dealing with a business combination "or otherwise..." may consider in addition to the interests of the corporation's shareholders" the interests of various enumerated nonshareholder constituencies, including "employees, suppliers, creditors and customers," and may also consider "the economy of the state and nation" and "[c]ommunity and societal considerations." Although no Kentucky decisions have ever offered an interpretation of this constituency statute, on its face the statute is extremely broad in its applicability. Specifically, the "or otherwise" language makes clear that the right of a corporate board to make decisions that benefit nonshareholder constituencies at the expense of shareholders is not limited to actions taken by the board in the midst of fights for corporate control. The "or otherwise" language expands the application of the Kentucky constituency statute to any board decision.

While broadly applicable on its face, it seems certain that Kentucky courts would never read Kentucky's constituency statute to permit directors to make unlimited wealth transfers from shareholders to nonshareholder constituencies. Especially when one considers the strong language from Kentucky cases confirming managers' obligations to shareholders, it is highly likely that Kentucky courts would impose a reasonableness limitation on the extent to which directors "may consider" the interests on nonshareholder constituencies. This interpretation and analysis suggests how Kentucky courts would handle a number of important fiduciary issues.

2. Charitable Contributions

Consider first the matter of charitable contributions. The Kentucky statute explicating the "powers" of a corporation allows the corporation "to do all things necessary or convenient to carry out its business and affairs, including without limitation power to ... [m]ake donations for the public..." The Kentucky statute deals only with corporate boards and thus provides no protection for majority shareholders or officers or agents who seek to serve the interest of constituencies other than shareholders. See id. ("[T]he board of directors, in considering the best interests of the corporation, may consider... ".)

Id. (emphasis added).

See supra notes 34-38 and accompanying text.
welfare or for charitable, scientific or educational purposes." Although this statute considered by itself may be unclear regarding the right of a board to authorize charitable contributions that do not enhance shareholder wealth, reasonable amounts of such contributions are certainly permitted under Kentucky's constituency statute.\footnote{K.R.S. § 271B.3-020(1)(m).}

The result should give the good corporate citizens of Kentucky plenty of room to make generous charitable contributions. Kentucky boards can make unlimited contributions that further the interests of the corporation's owners, and one should assume that courts will protect the board's decision in that regard under the business judgment standard.\footnote{The result of putting these two statutes together is to interpret Kentucky law consistent with the Principles of Corporate Governance regarding the propriety of maintaining an unprofitable division for the benefit of employees and the community. PRINCIPLES OF CORP. GOVERNANCE § 2.01 cmt. i.} In addition to amounts donated in the best interests of the company and its shareholders, the board could also authorize a quantitatively reasonable amount of charitable contributions unrelated to the economic best interests of the company.

3. Actions that Benefit Employees and the Community

Because the Kentucky constituency statute permits the board to consider the interests of "employees" and the "community," one should imagine that Kentucky would reach an outcome similar to the Principles of Corporate Governance regarding the propriety of maintaining an unprofitable division for the benefit of employees and the community.\footnote{For a discussion of the business judgment doctrine under Kentucky law, see infra notes 79–96 and accompanying text.} Quantitatively reasonable expenditures by a board "to provide the employees at the plant a period of adjustment prior to its closing"\footnote{See supra notes 32–35 and accompanying text.} would undoubtedly be proper under Kentucky law, even though such expenditures could reduce shareholder wealth. On the other hand, Kentucky courts, similar to the illustration from the Principles of Corporate Governance, are unlikely to read Kentucky's constituency statute to permit unreasonably large numbers of transfer payments to employees generated by keeping the plant open indefinitely.\footnote{PRINCIPLES OF CORP. GOVERNANCE § 2.01 illus. 20 (1992).}
4. Responses to Acquisition Overtures and the Right to "Just Say No"

The obligation under Kentucky law to maximize shareholder wealth and the quantitatively reasonable carve-outs of the Kentucky constituency statute are also important to the way in which boards respond to acquisition overtures.

Consider a situation in which a corporate board employs a "just say no" defense. Assume that, in response to an unsolicited takeover bid, the board of the target company deploys a poison pill that makes it impossible for the bidder to complete the acquisition. If one assumes that the bidder's offer is two times the present market value of the target's stock, and also two times the value of the company under its present management or any other management, the duty under Kentucky law to maximize the wealth of shareholders obligates the board to facilitate the acquisition by the bidder. Even if the target's employees and creditors would be better off under present management, the target's board must release the pill. Under these facts, the loss to shareholders in not selling into the superior bid is too great to be within the reasonable carve-out wrought by the Kentucky constituency statute. If, on the other hand, the bid were only five percent above the value of the company under existing management, protecting the interests of employees and creditors may well justify refusing to release the pill. That smaller amount of loss to shareholders for the protection of the nonshareholder constituencies may be within the permitted range of consideration appropriate for nonshareholder constituencies under Kentucky's constituency statute.

Next consider a situation like Revlon, where two bidders are competing for the acquisition of a target in a situation that clearly involves a change in control of the target company. Assume that the board of the target favors Bidder A and that Bidder A will protect the value of the company's credit instruments and the interests of the company's employees. Bidder B, on the other hand, will not protect the interests of creditors or employees if it is successful in acquiring the target. Once again, the target's board may not, consistent with its fiduciary duties, facilitate an acquisition by Bidder A if Bidder B will pay 100% more for the target's stock than Bidder A will pay. Under Kentucky's constituency statute, however, the target's board may perhaps facilitate the acquisition by Bidder A if Bidder B's price is only five percent above that of Bidder A's. This smaller amount may be within the range of permissible consideration allowed to nonshareholder constituencies under Kentucky law.

An analysis of Kentucky law, therefore, suggests no distinction between the situation when a target company is resisting a takeover bid, and thus attempting to remain independent, and the situation when the company is clearly going to be sold and the only question is to whom. The broad obligation of the target's board in both situations is exactly the same, and it is, subject to the reasonable carve-out from the constituency statute, a duty to maximize shareholder wealth. Under Kentucky law, there is no basis for the notion that a target board can hide behind a pill, if that is contrary to their obligation to maximize shareholder wealth. A "just say no" defense is subject to the same fiduciary scrutiny as any other board action.51

5. Summary

One should expect Kentucky to continue to define the overarching obligation of corporate fiduciaries in terms of the obligation to pursue the best interests of shareholders. This obligation is subject, however, to the right of directors52 to pursue within reasonable limits the best interests of nonshareholder constituencies, even at the expense of shareholders.53

51 The court in Revlon reaches conclusions different from the ones I draw about Kentucky law. First, the court declares that the board's duties change once the target is to be sold. See id. at 182. Second, the court states that once that point is reached, "concern for non-stockholder interests is inappropriate," and the obligation of the board is "the maximization of the company's value at a sale for the stockholders' benefit." Id. These are unsound and confusing rules.

There is no reason to change to the board's obligation to the corporate constituencies in the case of a sale of the company. The moral and economic claims for nonshareholder constituencies do not change depending on whether or not the company is for sale. There certainly is no hint in Kentucky law that the right to consider to a reasonable extent the interests of nonshareholder constituencies is lost when the company is put up for sale. Indeed, such a position would seem to be inconsistent with Kentucky's constituency statute.

Another problem with Revlon is that one is left at a loss regarding the obligation of managers prior to the point at which the company is put up for sale. One possible way to interpret Revlon is to read it as allowing a reasonable carve-out on behalf of nonshareholder constituencies prior to the point the company is put up for sale, and allowing no such carve-out once the company is on the block. That interpretation, however, does not answer the question of why the right to make such a reasonable carve-out disappears when the company is put up for sale.

In any event, Kentucky law seems to support a uniform duty on the board in an acquisition situation. The duty is to promote the interests of shareholders, subject to the right to make limited transfer payments to the nonshareholder constituencies enumerated in Kentucky's constituency statute.

52 The Kentucky constituency statute applies only to the "board of directors." K.R.S. § 271B.12-210 (Banks-Baldwin 2004). It is uncertain the extent to which, if at all, officers of a Kentucky corporation may pursue a course of conduct that promotes nonshareholder constituencies at the expense of shareholders. As described earlier, Delaware's common law has established what may be viewed as the equivalent of a constituency statute. See supra notes 24–29 and accompanying text.

53 In concluding this section, it is worth re-emphasizing that the carve-outs that empower Kentucky boards to pursue the interests of nonshareholder constituencies at the expense of shareholders amount to a right for the board as opposed to an obligation. Thus,
III. FIDUCIARY PRINCIPLES RESPECTING DISCRETE DECISIONS
AND RESPECTING MONITORING

A. Generally—Discrete Decisions; Monitoring

Typically, managers' duties are separated into discrete decision-making and monitoring functions, and different fiduciary standards are applied to these two separate management functions.

B. Discrete Decisions

1. The Law Generally

The fiduciary obligations applicable to managers' discrete decisions are often described under the rubrics of duty of care and duty of loyalty. Typically, the duty of care obligates managers not to make careless decisions that are hurtful to their corporation, and the duty of loyalty obligates managers to act fairly in relation to their corporation.

A more illuminating approach to the fiduciary duties applicable to managers' discrete decisionmaking, however, focuses on the existence and a corporate board would not violate its fiduciary duties by facilitating a highly leveraged acquisition that expropriates for shareholders a significant amount of creditor value or is contrary to the best interests of employees or the community. No fiduciary duties are owed to any of those constituencies. On the other hand, the board would violate its fiduciary duties by facilitating an unreasonable amount of wealth from shareholders on the one hand to creditors or employees on the other.

For example, the Principles of Corporate Governance provides for an overall negligence standard for directors or officers, but this gives way to the more lax business judgment standard in situations where discrete decisions are involved. PRINCIPLES OF CORP. GOVERNANCE § 401(c) ("A director or officer who makes a business judgment in good faith fulfills the duty ... if [he or she] ... rationally believes that the business judgment is in the best interests of the corporation.").

This, for example, is the way standard law school case books order their presentation of fiduciary duties. See, e.g., EISENBERG, supra note 21, at 520, 599.

the extent of any conflict of interest within which the particular corporate managers may be operating. This analysis is based on the recognition that courts, in evaluating the propriety of managers’ decisionmaking, will require an enhanced duty of managers when their actions are conflicted. Courts have utilized both a procedural mechanism and a substantive standard to deal with conflicted decisionmaking by fiduciaries. Procedurally, as the conflict intensifies for the fiduciary, courts tend to reallocate the burden of proof to the defendant—the fiduciary. Substantively, as the fiduciary’s conflict intensifies, courts tend to abandon forgiving standards—gross negligence, for example—and require higher levels of care—negligence, for example.

Three classic corporate fiduciary duty cases—Van Gorkom, Weinberger, and Revlon—are illustrative of the way courts have dealt with these matters.

Van Gorkom involved non-conflicted actions by the board of Trans Union facilitating a friendly, arm’s length acquisition of Trans Union by the Pritzker interests. In evaluating the propriety of the board’s actions, the court applied the business judgment test. Procedurally, the business judgment test allocates the burden of proof to the plaintiffs. Substantively, this test obligates the directors to act reasonably in investigating the decision and not to be grossly negligent at the decisionmaking stage. As applied in Van Gorkom, this required Trans Union’s board reasonably to investigate the question of whether the Pritzker bid maximized shareholder

62 See Van Gorkom, 488 A.2d at 873.
63 The court speaks in terms of a “presumption” in favor of the directors. Id. at 872 (“[T]he party attacking a board decision as uninformed must rebut the presumption.”). For a criticism of this language, see infra notes 95–105 and accompanying text.
64 The Van Gorkom court makes utter hash of the substantive standards of care to be used in business judgment cases, using two different standards of care to describe both the fiduciary’s duty at the inquiry stage and the fiduciary’s duty at the decisionmaking stage.

In discussing directors’ obligations under the business judgment standard at the inquiry stage, the court at one point states the obligation in terms of a duty to inform themselves, “prior to making a business decision, of all material information reasonably available to them.” Id. at 872 (quoting Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984)) (emphasis added). On the next page of the opinion, however, the court states that “the concept of gross negligence is also the proper standard for determining whether a business judgment . . . was an informed one.” Van Gorkom, 488 A.2d at 873 (emphasis added). In its conclusion, the court confuses the standard applicable at the decisionmaking stage by declaring that “Trans Union’s Board was grossly negligent in that it failed to act with informed reasonable deliberation.” Id. at 881 (emphasis added).
wealth, and the board’s decision to approve and support the acquisition must not have been grossly negligent on this point. The business judgment rule, therefore, is deferential to and protective of directors. Procedurally, it puts complaining shareholders to their proof, and substantively it exonerates directors for poor decisions unless those decisions were so stupid as to amount to an extreme deviation from ordinary care.

*Weinberger* involved a deeply conflicted action by the board of UOP when it facilitated the freezeout of UOP’s minority shareholders through a merger of UOP into Signal, UOP’s controlling shareholder. In evaluating the propriety of the actions of the board of UOP, the court used the intrinsic fairness standard, which procedurally shifts the burden of proof to the defendants and changes the applicable substantive standard to a demanding “fairness” test. Compared to the business judgment standard, the intrinsic fairness standard is much more demanding on a board accused of improprieties, since it holds the board to a materially higher standard and reassigns to the board the burden of establishing compliance with that higher standard.

In *Revlon*, the depth of the board’s conflict was somewhere between the deep conflict in *Weinberger* and the unconflicted setting in *Van Gorkom*. *Revlon* was hit with a hostile takeover bid from Pantry Pride. In response, the board deployed a number of defensive measures designed to...
thwart Pantry Pride’s bid and to ensure that the competing white knight,\(^{72}\) Forstman Little, would be the successful acquirer of Revlon.\(^{73}\) The court, in evaluating the propriety of the defensive tactics used by Revlon, concluded that a board reacting to hostile bids operates under the “specter” of a conflict,\(^{74}\) which means that the depth of the conflict is somewhere between an unconflicted situation (\textit{Van Gorkom}) and a deep conflict (\textit{Weinberger}). In such a quasi-conflicted situation, the fiduciary principles applied by the \textit{Revlon} court were a blend of business judgment and intrinsic fairness. The burden of proof was assigned to the defendant, similar to an intrinsic fairness case.\(^{75}\) The substantive standard applied was similar to the business judgment standard,\(^{76}\) except the criterion applied to the actual decisionmaking—the decision to approve the deployment of the defensive tactics—was enhanced to a reasonableness, or negligence, standard, as opposed to the gross negligence standard applied to the decisionmaking in a business judgment case. The language of the case required that the actual decision to deploy defensive tactics must have been “\textit{reasonable} in relation to the threat posed.”\(^{77}\)

Considered together, these three cases demonstrate the enhanced scrutiny courts give to discrete decisions made by corporate fiduciaries as the decisionmaker’s conflict deepens. They show that this enhanced scrutiny takes the form of the application of higher substantive standards to the fiduciary’s conduct and a reassignment of the burden of proof.

This analysis provides a workable analytical framework with which to evaluate and understand what is expected of fiduciaries. In short, if the fiduciary is unconflicted, she will be held to a negligence standard at the investigation stage, a gross negligence standard at the decisionmaking stage, and the burden of proof will be on the plaintiff. If the fiduciary is in a quasi-conflicted situation, she will be held to a negligence standard at the investigation stage, negligence at the decisionmaking stage, and the burden will be on the fiduciary to justify her conduct under that standard. Finally,

\(^{72}\) A “white knight” is a “person or corporation that rescues the target of an unfriendly corporate takeover, esp. by acquiring a controlling interest in the target corporation or by making a competing tender offer.” \textsc{Black’s Law Dictionary} 1591 (7th ed. 1999).

\(^{73}\) \textit{Revlon}, 506 A.2d at 178.

\(^{74}\) The court found “the omnipresent specter that a board may be acting primarily in its own interests, rather than those of the corporation and its shareholders.” \textit{Id.} at 180 (quoting \textit{Unocal Corp. v. Mesa Petroleum Co.}, 493 A.2d 946, 954 (1985)).

\(^{75}\) \textit{Id.} (“This potential for conflict places upon the directors the burden of proving . . . .”).

\(^{76}\) \textit{Id.} (stating that directors must show “good faith and reasonable investigation”).

\(^{77}\) \textit{Id.} (emphasis added).
if the fiduciary is deeply conflicted, she will be held to a fairness standard and will bear the burden of proof.

2. Kentucky Law

Kentucky law similarly suggests that fiduciary duties should intensify as the depth of the corporate fiduciary's conflict increases.78

a. Non–Conflicted Discrete Decisions

i. Kentucky’s Business Judgment Statutes: Standards of Conduct

Considering first non–conflicted actions, Kentucky has two applicable statutes: one applies to directors79 and the other applies to officers.80 Each offers the respective, unconflicted fiduciaries the protection of the business judgment standard.81

78 This is best demonstrated by a number of Kentucky cases which over the years have indicated that enhanced fiduciary standards apply to corporate managers who are conflicted. See Levitan v. Stout, 97 F. Supp. 105, 116–17 (W.D. Ky. 1951) (applying Kentucky law) (holding directors liable only for actual fraud or constructive fraud, defining constructive fraud as harmful, conflicted actions, even if done in good faith with no purpose to harm); Venus Oil Corp. v. Gardner, 50 S.W.2d 537, 538 (Ky. 1932) (“[T]he court may not intervene or interfere in the internal affairs of a corporation at the instance of minority stockholders, unless its governing authorities have acted or are threatening to act fraudulently, in the broad sense, against them or have abused the implied trust reposed in officers and directors in such manner or to such extent as to warrant the interposition of equity.”); Enter. Foundry & Mach. Works v. Miners’ Elkhorn Coal Co., 45 S.W.2d 470, 474 (Ky. 1931) (“When the directors themselves ... mortgage or sell the property of the corporation to themselves ... a different rule obtains from that where the property is sold to a third person in good faith and for a valuable consideration.”); Haldeman v. Haldeman, 197 S.W. 376, 381 (Ky. 1917) (“The courts will not interfere with this management confided in the officers of the corporation so long as it keeps within the limits of its charter, and does not act fraudulently.”); Beha v. Martin, 171 S.W. 393, 395 (Ky. 1914) (“A)option [of the conflicted transaction] must not be brought about by unfair or improper means, and must not be illegal or fraudulent, or oppressive towards those stockholders who oppose it.”); Pouch v. Nat’l Foundry & Mach. Co., 143 S.W. 1003, 1004 (Ky. 1912) (“The presumption is that directors act in their own interest ... [when they vote a salary to themselves], and that the burden of proof is on them to show the fairness of the transaction.”); Allied Ready Mix Co. v. Allen, 994 S.W.2d 4, 9 (Ky. App. 1999) (applying different standards in judging propriety of conduct of a special litigation committee and a board, depending on whether demand was made or excused).

79 K.R.S. § 271B.300 (Banks–Baldwin 2004).

80 § 271B.420.

81 Neither statute on its face distinguishes between conflicted and unconflicted decisions. It seems certain, therefore, that the statutes would cover unconflicted decisions of officers and directors. Later I argue against extending the protection of the statutes to
Kentucky's business judgment statutes, similar to the articulation of the business judgment standard from *Van Gorkom*, bifurcate the fiduciary's action into the inquiry stage and the decisionmaking stage and require different standards for each. Thus, they require the fiduciary to act in "good faith" and, at the investigation stage, to make her "inquiry" "with the care an ordinarily prudent person in a like position would exercise under similar circumstances." At the decisionmaking stage, Kentucky business judgment, similar to *Van Gorkom*, lowers the expectations for the fiduciary. The fiduciary has complied with her duties if she "honestly believes [the decision or action] to be in the best interests of the corporation."

The Kentucky business judgment provisions do not address the matter of the burden of proof when, for example, disgruntled shareholders press a breach of fiduciary duty claim against the directors of a corporation. As a result, the normal rule would apply, which allocates the burden of proof obligation to the plaintiff. This is the same allocation rule that generally applies in business judgment cases outside Kentucky.

The Kentucky business judgment statutes, by clearly articulating negligence as the standard applicable at the inquiry or investigation stage, avoid the confusion wrought by the *Van Gorkom* court, which articulated the inquiry duty both in terms of a negligence and a gross negligence standard. On the other hand, the meaning of "honestly believes," which is the applicable standard under Kentucky's business judgment statutes for nonconflicted managers at the decisionmaking stage, requires some interpretation. No Kentucky court has ever had occasion to interpret this

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82 K.R.S. § 271B.300.
83 The Kentucky statute governing directors' fiduciary obligations states:
(1) A director shall discharge his duties as a director, including his duties as a member of a committee:
   (a) In good faith;
   (b) On an informed basis; and
   (c) In a manner he honestly believes to be in the best interests of the corporation.
(2) A director shall be considered to discharge his duties on an informed basis if he makes, with the care an ordinarily prudent person in a like position would exercise under similar circumstances, inquiry into the business and affairs of the corporation, or into a particular action to be taken or decision to be made.

Id. The statute governing officers' fiduciary obligations contains similar language. See id. § 271B.8-420.
84 See supra note 60 and accompanying text.
86 See supra notes 61–62 and accompanying text.
87 See supra note 75 and accompanying text.
standard. Both the words of the statute and persuasive authority, however, strongly suggest that the "honestly believes" standard should be interpreted as the equivalent of gross negligence. Gross negligence, in turn, is best described as an extreme departure from ordinary care.\textsuperscript{88}

The standard, "honestly believes," on its face suggests both an objective and subjective component. Subjectively, one must "believe" that the action is in the best interests of the corporation. Objectively, one's belief must be "honestly" held.\textsuperscript{89} By using the word "honestly" instead of "reasonably," the legislature relaxes the objective standard applied to fiduciaries when they make discrete decisions, suggesting with some force a gross negligence standard. Restated, one should not be considered "honestly" to believe that an action is in the best interests of the corporation if that belief is so unreasonable as to amount to an extreme deviation from ordinary care.

Looking beyond Kentucky decisions, both \textit{Van Gorkom} and the \textit{Principles of Corporate Governance} provide some insight into the appropriate interpretation of the requirement that fiduciaries "honestly believe" their decisions or actions benefit the corporation. Both of these sources suggest that Kentucky's "honestly believe" standard is best understood as the functional equivalent of gross negligence. The \textit{Van Gorkom} court, at different points in the opinion, in fact uses both "honest belief" and "gross negligence" to describe the duties of fiduciaries at the decisionmaking stage.\textsuperscript{90} This suggests, then, that the \textit{Van Gorkom} court considers the two different terms to be functional equivalents.

The \textit{Principles of Corporate Governance} opts for a "rationally believes" standard at the decisionmaking stage.\textsuperscript{91} On its face, this articulation also seems functionally equivalent to a gross negligence standard and Kentucky's "honestly believes" standard, and the comments to the \textit{Principles} support this conclusion.\textsuperscript{92} The comments expressly recognize that the "rationally believes" standard is less rigorous than negligence and defend the appropriateness of this more relaxed standard on the basis of the "[s]ound public policy" of according the managers "greater

\textsuperscript{88}See supra note 62.
\textsuperscript{89}This is identical to the explanation offered in the Comments to the \textit{Principles of Corporate Governance} for the term "rationally believes." See the discussion infra at note 93–95 and accompanying text. The Comments to the \textit{Principles} explain the "rationally believes" standard as containing both a subjective component—the manager "must actually believe" the action is best for the company—and an objective component—the manager's belief "must be rational." \textit{PRINCIPLES OF CORP. GOVERNANCE} § 4.01(c) cmt. f.
\textsuperscript{90}See supra note 60.
\textsuperscript{91}\textit{PRINCIPLES OF CORP. GOVERNANCE} § 4.01(c).
\textsuperscript{92}\textit{Id.} cmt. f.
protection” than they would get under a negligence standard. At the same time the comments reject a purely subjective interpretation of the “rationally believes” standard because it “provide[s] too much legal insulation for directors and officers.” Thus, the “rationally believes” standard requires more culpability than mere simple negligence but is not predicated on subjective knowledge. This seems, therefore, to be functionally equivalent to a gross negligence or “honestly believes” standard.

An economic analysis also supports interpreting Kentucky’s “honestly believes” standard as the equivalent of gross negligence. It is easy to imagine that the parties to the fiduciary duty “contract” (i.e., corporate managers and shareholders) would opt for a gross negligence, or “extreme deviation from ordinary care,” standard at the decisionmaking stage. While shareholders may prefer a negligence standard, rational managers would charge a higher fee to operate under such a tough standard, and shareholders may well conclude that the additional protection they receive from the higher standard is not worth the cost. On the other hand, shareholders probably would be willing to pay for more care than they would receive under a purely subjective standard. In short, a gross negligence standard seems to be an efficient term since it approximates the term the parties would select.

Kentucky courts, when offered the opportunity to interpret and apply its business judgment statutes, should equate “honestly believes” to gross negligence or recklessness. This interpretation is consistent with the words of the statutes and supported by persuasive authority and sound logic.

ii. Failure to Meet the Predicates of Kentucky’s Business Judgment Statute

One interpretative issue that has been resolved poorly by courts outside Kentucky involves the question of what happens when a plaintiff is able to

93 Id.
94 Id.
95 In attempting to explain the meaning of the “rationally believes” criterion, the comment provides additional support for this conclusion by suggesting the “rationally believes” standard would not be met if the decision is “so removed from the realm of reason that it should not be sustained.” Id.
96 See supra notes 4–6 and accompanying text for a brief description of the economic analysis of corporate fiduciary duties.
show that the corporate fiduciary failed to meet any of the predicates of the business judgment standard.97

The most typical situation involves a failure of the fiduciary–defendant to meet the obligation to conduct a reasonable inquiry into the proposed corporate action. When this happens, the fiduciary–defendant is denied the protection of the forgiving “gross negligence” (or “honestly believes” or “rationally believes”) standard at the decisionmaking stage and, instead, is subjected to the rigorous intrinsic fairness evaluation, in which the fiduciary–defendant has the burden of proving that the transaction was fair to the plaintiffs.

This approach was articulated in the Cede case, where a Delaware court concluded that Technicolor’s directors “failed to inform themselves fully concerning all material information reasonably available prior to approving the merger agreement.”98 The court concluded that because the directors “breached . . . one of the triads of their fiduciary duty—good faith, loyalty or due care . . . the burden shifts to the [defendant directors] . . . to prove to the trier of fact the ‘entire fairness’ of the transaction.”99

The Kentucky statute does not suggest this approach, and it would be unsound as a matter of policy for the courts to adopt this complicated, convoluted, and circuitous procedure. Instead, the Kentucky statute sensibly suggests that a failure to meet any of the three elements of the statute—good faith, reasonable inquiry, or an honest belief that the decision is in the best interests of the corporation—converts the case into a matter of remedy or damages.100 The elements are held together in the statute by the conjunctive “and,”101 which suggests that each element independently is required by and equally important to the business judgment duties of the fiduciary. The logical implication of the statutory language, therefore, is that any harm resulting from the failure to comply with any of the three should produce a remedy for complaining shareholders. This direct and logical approach will help simplify and expedite fiduciary duty litigation and will properly focus the court on the construction of remedies that are appropriate to protect the interests of shareholders and of society.

97 See, e.g., Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 361 (Del. 1993) (“If the rule is rebutted, the burden shifts to the defendant . . . to prove . . . the ‘entire fairness’ of the transaction.”), modified, 636 A.2d 956 (Del. 1994).
98 Id. at 371.
99 Id. at 361.
100 See K.R.S. § 271B.8-300(5) (Banks–Baldwin 2004).
101 §§ 271B.300(1), 271B.8-420(1).
iii. Kentucky's Limitation on Monetary Damages

Kentucky statutes impose an additional hurdle on one important remedy that shareholders may seek against officers and directors who violate their fiduciary duties. Under the Kentucky statutes, a recovery of "monetary damages" against directors or officers who violate their fiduciary duties is predicated on a finding that the director's or officer's actions "constitute[] willful misconduct or wanton or reckless disregard for the best interests of the corporation and its shareholders."\(^1\)

This statute applies only to the matter of monetary recovery against fiduciaries who violate their fiduciary duties; it does not, therefore, change Kentucky's business judgment standard as such or insulate Kentucky directors or officers from other shareholder remedies.

Although this statute appears to be designed to make it more difficult to collect monetary damages against corporate managers, a close analysis shows that it likely has little impact on directors and officers at the decisionmaking stage. As described above, Kentucky's business judgment statutes subject directors and officers to an "honestly believes" standard when they make decisions,\(^2\) and that "honestly believes" standard should be considered the functional equivalent of the "reckless disregard" standard that is the statutory predicate to monetary recovery.\(^3\)

On the other hand, this statute may well have an impact on the ability to obtain monetary damages for failures by fiduciaries at the investigation stage. Under Kentucky's business judgment statutes, a manager fails the business judgment test if he fails to make inquiry "with the care an ordinarily prudent person in a like position would exercise under similar circumstances."\(^4\) The statute limiting monetary damages, however, insulates managers from monetary liability unless the failure to inquire is so extreme as to amount to a "reckless disregard for the best interests of the corporation and its shareholders."\(^5\) In short, while a negligent investigation violates the manager's fiduciary duty under Kentucky's business judgment law, the manager is not liable for monetary damages unless the investigation is so poorly done that it amounts to an extreme departure from

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\(^1\) § 271B.8-300(5)(b) (providing for monetary damages against directors); see also § 271B.8-420(5)(b) (providing for monetary damages against officers). The two sections use identical language.

\(^2\) See supra notes 82–83 and accompanying text.

\(^3\) See supra note 78.

\(^4\) See discussion supra note 78.

\(^5\) K.R.S. § 271B.8-300(2).

\(^6\) § 271B.8-300(5)–(6).
ordinary care. As stated above, however, courts would be free—indeed, obligated—to construct non-monetary remedies on behalf of shareholders who are able to demonstrate that officers or directors harmed them or the corporation as a result of a negligent inquiry.

iv. Standard of Care or Standard of Review?

For some time, Delaware courts deciding business judgment cases have defined their role in terms of applying a scope of review, as opposed to evaluating compliance with a standard of conduct imposed by society. If this initial statement seems confusing, further explanation of the interplay between these concepts only makes it more so.

In a note in his widely adopted casebook, Professor Eisenberg explains this approach. He first defines a "standard of conduct" as a rule defining "how an actor should conduct a given activity or play a given role." In all duty-of-care cases, Professor Eisenberg states that the standard of care is reasonableness. Restating this standard of care in the negative, directors owe the duty not to act negligently or unreasonably in regard to their functions as directors. Eisenberg defines a "standard of review," on the other hand, as "the test a court should apply when it reviews an actor's conduct to determine whether to impose liability or grant injunctive relief."

He then explains the business judgment rule as a standard of review concept—a doctrine that determines under what conditions and to what extent courts will review the discrete decisions made by corporate boards. Applying this concept, if in making a discrete decision a director "informed himself...to the extent he reasonably believes appropriate," acts in "good faith" and has no "financial interest in the subject matter of the decision," then "the quality of a directors' decision will be reviewed [by a court], not to determine whether the decision was reasonable, but only under a much more limited standard," which Eisenberg suggests is a "rational" standard.

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107 For a discussion of "recklessness" as an "extreme departure" from ordinary care," see supra note 67.
108 See, e.g., Omnicare, Inc. v. NCS Healthcare, Inc., 818 A.2d 914, 927 (Del. 2003) (characterizing the business judgment rule as "a standard of judicial review") (citing MM Cos. v. Liquid Audio, Inc., 813 A.2d 1118, 1127 (Del. 2003)).
109 EISENBERG, supra note 21, at 544.
110 Id.
111 Id. at 546. This "rational" standard seems to be the functional equivalent of gross negligence or honestly believes. See supra notes 64–67 and accompanying text.
Chief Justice E. Norman Veasey of the Supreme Court of Delaware explained all of this in terms of aspirations and liability. The negligence standard of conduct, he says, is “aspirational,” which apparently means that it is the standard to which society believes corporate fiduciaries should aspire. The gross negligence (or “rationally believes” or “honestly believes”) standard of review, on the other hand, is the standard that will be applied by courts when they are asked to determine whether fiduciaries should have any liability for acts that cause harm to the corporation.  

Generally, however, society attempts to reach an aspirational goal by making that goal mandatory and providing an economic incentive for people to live up to that goal or standard. If we want motorists to drive thirty-five miles per hour in a school zone, we set the speed limit at that speed and fine people who violate the speed limit. Enforcing a sub-optimal standard makes sense only if the additional costs associated with enforcing the optimal (or aspirational) standard exceed the benefits that society garners from enforcing the higher, optimal (aspirational) standard as compared to the lower, sub-optimal standard.

Considering both the cost and the benefit, it is hard to imagine how society could gain by enforcing a sub-optimal duty-of-care standard. The difference in economic costs between enforcing a negligence duty-of-care standard and a recklessness duty-of-care standard seems to be negligible. If, therefore, enforcement costs are roughly the same, society should opt in favor of the standard that produces the highest benefit, which Justice Veasey and Professor Eisenberg both seem to assume is a

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113 In the tort area, for example, law and economics scholars discuss a negligence regime of tort recovery in terms of damages set at a level that will encourage efficient investment in accident reduction. Typically, law and economics scholars believe that recovery for full economic loss promotes economic efficiency. The threat of damages at that level will encourage potential tortfeasors to make the necessary investments and conduct alterations to avoid committing inefficient accidents. See Richard A. Posner, Economic Analysis of Law 192–200 (6th ed. 2003) (discussing the economic theory of tort damages).

114 See id. at 219–27 (discussing the use of fines as efficient criminal sanctions).

115 Society’s out of pocket costs in administering the standards appear to be the same. Also, there is no reason to expect significant differences in other economic costs, such as the economic costs associated with overdeterrence. See id. at 221 (discussing the economic costs that result when overly excessive penalties cause citizens “to forgo socially desirable activities at the borderline of” the prohibited activity, as a way to establish a safety buffer against inadvertent violation of the law).
negligence standard.\textsuperscript{116} Thus, not only is the Delaware standard of review approach confusing and complex and based on a false analogy,\textsuperscript{117} but the approach also amounts to bad policy.

The Kentucky business judgment statutes seem clear on this matter: Kentucky has established as a standard of care a duty on the part of fiduciaries to act reasonably at the inquiry stage and a duty of care at the decisionmaking stage to act in a manner that does not amount to gross negligence. There is no basis in sound policy or in Kentucky law for a resort to the confusing and misdirected standard of review analysis adopted by Delaware.

\textbf{b. Deeply Conflicted Discrete Decisions}

It seems highly likely that Kentucky courts, like the courts of Delaware, would apply an intrinsic fairness test to evaluate the propriety of deeply conflicted actions taken by corporate fiduciaries.\textsuperscript{118} While the law on this matter is not without some ambiguity, Kentucky statutes and cases and sound policy support an intrinsic fairness standard in conflicted situations.

\textsuperscript{116} This should not be read as an endorsement of a negligence standard of care. In fact, my own view is that a gross negligence standard at decisionmaking may amount to an efficient term that is entirely appropriate as an economic and fairness matter. The point here is that the determination should be approached as a direct standard of care issue and should not be confused or misdirected by a standard of review analysis.

\textsuperscript{117} Typically, courts apply standard of review concepts to their review of the decisions of lower courts or administrative agencies. Considering, for example, a court’s review of an administrative agency’s decision, sound reasons exist for the court’s deference to the judgment made by the agency. The agency is viewed as independent (unconflicted) and an expert in its area. ALFRED C. AMANI, JR. & WILLIAM T. MAYTON, ADMINISTRATIVE LAW 434–523 (1993) (discussing judicial review of administrative decisions); Michael P. Healy, \textit{Spurious Interpretation Redux: Mead and the Shrinking Domain of Statutory Ambiguity}, 54 ADMIN. L. REV. 673 (2002) (discussing deference courts pay to administrative decisions in the face of ambiguous legislative delegations of authority to the agency). It is impossible to imagine that all (or perhaps even most) directors’ decisions are made in circumstances where directors are truly unconflicted experts regarding the particular decision.

\textsuperscript{118} Two cases in Kentucky may provide some guidance regarding the circumstances in which fiduciaries are considered “conflicted.” In \textit{Security Trust Co. v. Dabney}, 372 S.W.2d 401 (Ky. 1963), a director of a company to be acquired was not considered to be conflicted when he voted in favor of the acquisition, even though he was to continue as a director following the acquisition. The Kentucky Court of Appeals wrote that “we do not believe that the mere obtention of a directorship on the board following merger or consolidation creates a disqualifying self-interest.” \textit{Id.} at 406. The court in \textit{Brewer v. Lincoln International Corp.}, 148 F. Supp. 2d 792 (W.D. Ky. 2000), on the other hand, found a troubling conflict in a case in which a director of a company to be acquired had a significant property interest in the acquiring company and had been assured of his continuation as an officer following the acquisition. \textit{See id.}
Three Kentucky statutes must be considered here. First is a Kentucky statute that protects a deeply conflicted transaction from voidability if the transaction is approved by a prescribed shareholder or director vote, or if the transaction is fair.\(^{119}\) This statute, however, deals only with the enforceability of the terms of such a transaction, preventing, for example, either the corporation or the deeply conflicted fiduciary from failing to live up to the contractual terms of the transaction. The statute does not, therefore, speak directly on the matter of the appropriate standard for fiduciaries involved in deeply conflicted actions.\(^{120}\)

The other statutes to be considered are Kentucky's business judgment statutes, described in the preceding section. These statutes subject directors and officers to an overall good faith obligation and require that they act reasonably at the investigation stage and consistent with a more relaxed "honestly believes" standard at the decisionmaking stage. The statutes on their faces do not distinguish between conflicted and non-conflicted transactions, leaving open the possibility that these statutes could be applied to deeply conflicted transactions.

There are compelling reasons, however, to limit Kentucky’s statutory business judgment standard to situations in which non-conflicted fiduciaries make discrete decisions on behalf of their corporations. Perhaps most importantly, applying a business judgment standard to conflicted fiduciary actions would be inconsistent with long-established standards of Kentucky common law, standards that were in place at the time the present Kentucky business judgment statutes were enacted in 1988. For decades, Kentucky courts have drawn distinctions between the duties owed by conflicted fiduciaries, on the one hand, and non-conflicted fiduciaries on the other.\(^{121}\) In cases involving non-conflicted actions, the language from Kentucky cases suggests a substantive standard that is strongly deferential

\(^{119}\) K.R.S. § 271B.8-310 (Banks-Baldwin 2004). The statute states that a director’s “conflict of interest transaction shall not be voidable by the corporation solely because of the director’s interest in the transactions” if the transaction is approved by shareholders or directors, or if the transaction is “fair to the corporation.” Id.

More recent versions of the Model Business Corporation Act appear to move this provision more into the area of a fiduciary standard. See MODEL BUSINESS CORPORATION ACT § 8.61(b) (1991) (“A director’s conflicting interest transaction may not . . . give rise to an award of damages” if the transaction is approved by directors or shareholders, or is fair) (emphasis added).

\(^{120}\) By protecting against voidability when the transaction is “fair to the corporation,” however, the statute suggests fairness as an appropriate standard against which to measure the propriety of directors’ actions. K.R.S. § 271B.8-310.

\(^{121}\) See, e.g., Allied Ready Mix Co. v. Allen, 994 S.W.2d 4 (Ky. App. 1999) (applying different standards in judging propriety of conduct of special litigation committee and board, depending on whether demand was made or excused).
to corporate managers regarding the propriety of their actions and, in such cases, courts assign the burden of proof to the plaintiffs. On the other hand, when corporate fiduciaries act in conflicted settings, Kentucky courts have been willing to enhance the substantive standard and reassign the burden of proof to the conflicted fiduciaries. These policies—enhancing the standard and reversing the burden of proof in conflicted decisions—are the essence of the intrinsic fairness test.

Because the Kentucky business judgment statutes do not amount to clear legislative authorization for abandonment of Kentucky's traditional position, Kentucky courts should continue to apply more rigorous standards in deeply conflicted cases. It seems unlikely that the Kentucky legislature meant those statutes to abandon the well established Kentucky position of

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122 See, e.g., Levitan v. Stout, 97 F. Supp. 105, 116–17 (W.D. Ky. 1951) (applying Kentucky law) (stating that “directors are not liable to their corporation unless they are guilty of actual or constructive fraud,” and defining fraud as including conflicted decisions); Venus Oil Corp. v. Gardner, 50 S.W.2d 537, 538 (Ky. 1932) (“The court may not intervene or interfere in the internal affairs of a corporation . . . unless its governing authorities . . . act fraudulently, in the broad sense . . . or have abused the implied trust reposed in officers and directors in such manner or to such extent as to warrant the interposition of equity.”); Haldeman v. Haldeman, 197 S.W. 376, 381 (Ky. 1917) (“The courts will not interfere with this management confined in the officers of the corporation so long as it keeps within the limits of its charter, and does not act fraudulently.”); Poutch v. Nat’l Foundry & Mach. Co., 143 S.W. 1003, 1004 (Ky. 1912) (“[The] general rule is that the action of the directors must be a fraud on the corporation, actually or constructively, before the directors can be held liable.”).

123 See, e.g., Venus Oil Corp., 50 S.W.2d at 538 (placing the “burden . . . upon the objecting stockholders to establish” a fiduciary violation).

124 Levitan, 97 F. Supp. at 117 (holding that when a fiduciary is “in a position of conflict . . . courts will examine carefully into the results of the act and will hold the fiduciary liable if, despite his good intentions, his act resulted in injury”); see also Enter. Foundry & Mach. Works v. Miners’ Elkhorn Coal Co., 45 S.W.2d 470, 474 (Ky. 1931): When the directors deal with themselves in such a transaction, they are acting in a dual capacity . . . The presumption is unfavorable to them, and upon their acts being called in question . . . the burden is imposed upon them to show by a preponderance of proof that they acted bona fide and that the corporation got the benefit of their act.

Id.; Beha v. Martin, 171 S.W. 393, 395 (Ky. 1914) (“[T]he affirmation or adoption [of the conflicted transaction] must not be brought about by unfair or improper means.”); Poutch, 143 S. W. at 1004 (“[W]hen directors act in their own interest . . . the burden of proof is on them to show the fairness of the transaction.”).

125 See infra note 207 and accompanying text.

126 Even assuming the general applicability of the Kentucky business judgment statutes, a court could conclude that the obligation under the statutes to exercise “good faith” is not met when a conflicted fiduciary acts unfairly toward his corporation. Alternatively, a court could find that the fiduciary’s duty to “honestly believe” that a transaction is in the best interests of his corporation is not met when a conflicted fiduciary acts unfairly to his corporation.
Applying a common law intrinsic fairness standard to conflicted transactions also would put Kentucky in line with her sister states—most notably Delaware—and amount to sound policy. Conflicted fiduciaries need strong incentives to act in a manner that is consistent with society’s expectations and the expectations of the corporation’s owners. By shifting the burden to managers and enhancing the substantive standard to fairness, and then enforcing these enhanced obligations through the threat of judicially imposed remedies, conflicted managers are strongly and appropriately encouraged to pursue the best interests of the company’s owners.

A related economic argument also suggests the need for an intrinsic fairness standard in conflicted transactions. As described earlier, economists often defend the propriety of an outcome by reference to the agreement that the parties would reach, if they were able to bargain with one another. The idea is simple, logical, and morally attractive, since it is based on the notion of consent. Applied in the case of managers’ fiduciary duties in conflicted transactions, one can reasonably conclude that owners would likely demand and be willing to pay for more protection in the form of higher fiduciary standards. In conflicted transactions, the risks for the owners are greater than in the case of non-conflicted transactions, and it makes economic sense to assume that owners would pay more to eliminate the higher risk. For courts to apply an intrinsic fairness standard in such situations, therefore, may approximate the bargain that owners and managers would make in such conflicted situations.

In summary, one should expect Kentucky to continue, as it has in the past, to apply an intrinsic fairness standard to conflicted actions by corporate fiduciaries. This approach would be consistent with Kentucky statutes, cases, and precedents from other jurisdictions, and with sound policy.

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127 Although operating under prior corporate statutes, Steelvest, Inc. v. Scansteel Service Ctr., Inc., 807 S.W.2d 476 (Ky. 1991), and Aero Drapery of Kentucky, Inc. v. Engdahl, 507 S.W.2d 166 (Ky. 1974), are cases in which the Supreme Court of Kentucky appeared to resort to a common law version of fiduciary duties that was higher than, or at least somewhat more expansive of, the duties articulated in the statute. These cases, therefore, may support a view that the fiduciary duty statutes should be supplemented by the common law.


129 See supra notes 4–7 and accompanying text.
c. Quasi–Conflicted Decisions ("Specter" of a Conflict)^30

Although they have never considered the matter, I expect Kentucky courts to adopt the proportionality test as the fiduciary standard applicable to discrete decisions made by quasi–conflicted corporate managers. Under this test, which amounts to a middle ground between business judgment and intrinsic fairness, managers (defendants) have the burden of proving the reasonableness of their investigation and the reasonableness of their actual decision.\(^{131}\) Delaware courts have applied the proportionality test to actions taken by directors of a target when they deployed defensive tactics in response to an unsolicited bid for the target.\(^{132}\)

Once again, courts should not infer that Kentucky’s business judgment statutes foreclose the adoption of a proportionality test for quasi–conflicted management actions. It seems highly unlikely that the Kentucky legislature, in enacting the business judgment statutes, intended to abandon Kentucky’s long–standing common–law tradition of according shareholders enhanced and meaningful protection from managers’ conflicted actions.\(^{133}\) Absent a clear legislative directive, courts should be reluctant to expand the scope of Kentucky’s business judgment statutes into the area of conflicted actions—even quasi–conflicted actions.\(^{134}\)

Adopting a proportionality test for quasi–conflicted situations is a sensible implementation of Kentucky’s common–law tradition. In any given case, the depth of conflict faced by corporate fiduciaries might be anywhere from a very deeply conflicted transaction to a completely non–conflicted transaction. Two discrete bins—deeply conflicted and non–conflicted—do not, therefore, effectively accommodate the gradations of conflict within which fiduciaries may find themselves. This is the basis for the proportionality test. It offers courts an appropriate analytical framework for deciding cases in which fiduciaries are conflicted, but less so than in deeply conflicted cases, such as *Weinberger*, where directors who were nominees of the majority shareholder facilitated the freezeout of minority shareholders.

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\(^{130}\) In *Revlon*, the Delaware court characterized the situation in which a target board is faced with an unsolicited bid for their company as involving the board in a "specter" of a conflict. *Revlon v. MacAndrews & Forbes Holdings*, Inc., 506 A.2d 173, 180 (Del. 1985). In this paper, I sometimes refer to this as a "quasi–conflict" since the situation lies between a deeply conflicted and a non–conflicted situation.

\(^{131}\) See supra notes 75–77 and accompanying text.

\(^{132}\) *Revlon* is an example of this. For a discussion of *Revlon*, see supra notes 71–77 and accompanying text.

\(^{133}\) See supra note 78.

\(^{134}\) See supra notes 93–95 and accompanying text.
shareholders, or Globe Woolen Co. v. Utica Gas and Electric, where a director personally purchased electricity from his corporation.

The proportionality test, therefore, tailors fiduciary duties more closely to the nature and depth of the fiduciary's conflict. It is consistent with the common sense notion of imposing tougher fiduciary standards on corporate managers only to the extent necessary to protect shareholders from the pressures created by managers' self-interest.

The proportionality test is once again consistent with sound economic policy because it approximates the level of fiduciary protection that the parties would select if they were able to bargain with each other. Corporate shareholders, if able to bargain effectively with their managers about the nature and extent of the managers' fiduciary duties, would be inclined to tailor their purchases of fiduciary protection for their own economic benefit. Shareholders would, in other words, be unwilling to pay for fiduciary protection in excess of the minimum amount necessary to protect themselves in particular situations. Applied here, shareholders considering a quasi-conflicted situation would be unwilling to pay for the extreme level of fiduciary protection they demand in a deeply conflicted situation. If able to bargain, one should expect the parties—managers and shareholders—to agree on an intermediate level of fiduciary protection to cover quasi-conflicted situations. Thus, the proportionality test appears to be an efficient rule upon which rational parties might agree.

The proportionality test grew out of cases in which company directors took actions to ward off an unsolicited takeover bid for their company. Recently, Delaware courts have suggested an expanded applicability of the proportionality test, applying the standard to deal protection provisions that were part of a friendly acquisition.

135 See supra notes 93–95 and accompanying text.
137 See supra notes 4–7 and accompanying text.
138 In Omnicare, Inc. v. NCS Healthcare, Inc., 818 A.2d 914 (Del. 2003), the court expanded the applicability of the proportionality test beyond the context of contested acquisitions. In Omnicare, the board of NCS, the target of a friendly acquisition by Genesis Health Ventures, Inc., agreed to certain contractual provisions that made it essentially impossible for other bidders to compete for the acquisition of NCS. Even though at the time no other bidders were on the scene, and thus the acquisition was entirely friendly, the court refused to apply a business judgment standard, opting instead for the proportionality test to evaluate the propriety of the action of NCS’s board. The court stated that “defensive devices adopted by the board to protect the original merger transaction must withstand enhanced judicial scrutiny under the Unocal standard of review [i.e., proportionality test], even when that merger transaction does not result in a change of control.” Id. at 931.

Since the proportionality test has been reserved for instances in which a quasi-conflict is present (a “specter” of a conflict), the court explained the conflict it found in this friendly
Generally, expanding the applicability of the proportionality test makes perfect sense, and Kentucky courts should resort to this intermediate level of fiduciary duties any time they find that a manager’s action is conflicted, but not deeply so. A number of examples come readily to mind. Executive compensation, which traditionally has been evaluated under business judgment, may be an appropriate area for proportionality treatment. The influence of the CEO on her board may raise the “specter” of a conflict at least as deep as the conflict boards face in acquisitions. Kentucky courts should evaluate executive compensation by placing the burden on the board to establish that they acted reasonably at the investigation stage and at the decision stage.

Similarly, decisions involving the rights of non-voting preferred shareholders may also call for proportionality treatment. Board members owe fiduciary duties to preferred shareholders, but are elected by common shareholders. Decisions that have an impact on preferred shareholders—a classic example would be the decision to withhold non-cumulative preferred dividends—similarly raise a specter of a conflict that seems as deep as that found in acquisition cases.

In summary, the proportionality test is a fundamentally sound approach that finds support in Kentucky common-law traditions, is consistent with Kentucky statutes, and leads to outcomes that are sound as a matter of policy and economics. One should expect that Kentucky courts, when

situation:

There are inherent conflicts between a board’s interest in protecting a merger transaction it has approved, the stockholders’ statutory right to make the final decision to either approve or not approve a merger, and the board’s continuing responsibility to effectively exercise its fiduciary duties at all times after the merger agreement is executed.

Id. at 930. Omnicare may signal, therefore, an expanded use of the proportionality test and an expanded view of instances in which managers are faced with quasi-conflicts.


140 With regard to directors setting their own salaries, one old Kentucky case appears to apply the equivalent of an intrinsic fairness test. See Pouch v. Nat’l Foundry & Mach. Co., 143 S.W. 1003, 1004 (Ky. 1912) (“[T]he presumption is that directors act in their own interest . . . [when they vote a salary to themselves], and that the burden of proof is on them to show the fairness of the transaction.”).

141 See Jedwab v. MGM Grand Hotels, Inc., 509 A.2d 584, 594 (Del. 1986) (describing the distinctions between duties owed to preferred as compared to common stockholders).

142 For examples of this issue, see Sanders v. Cuba R. R. Co., 120 A.2d 849 (N.J. 1956) (applying the dividend credit rule), and Guttmann v. Illinois Central R.R. Co., 189 F.2d 927 (2d Cir. 1951) (rejecting the dividend credit rule).
offered the chance, will adopt the standard and will look for appropriate opportunities to expand the use of the proportionality test.

d. Final Overview

Considering Kentucky statutes and common law together, one could conclude that Kentucky's corporate fiduciary standards applicable to discrete actions taken by corporate managers will be determined by the existence and depth of any conflict of interest within which the fiduciary finds himself. One should expect, therefore, that Kentucky courts, when asked to evaluate the propriety of managers' actions, will apply the business judgment test to non-conflicted actions, the intrinsic fairness test to deeply conflicted transactions, and the proportionality test to conflicted transactions. While it is possible to find some language to the contrary in Kentucky cases, generally those cases are not only confusing and poorly reasoned but also are old, pre-dating Kentucky's more recent statutes and the modern development of fiduciary concepts generally. The language from those old cases should not be taken seriously.

C. Fiduciary Duties Applied to Monitoring

The duties as described in the immediately preceding section apply to discrete decisions made on behalf of corporations by their managers. Managers, however, and particularly boards of directors, also owe the duty to monitor the activities and the agents of the corporation. These

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143 See, e.g., Levitan v. Stout, 97 F. Supp. 105, 116–17 (W. D. Ky. 1951) (indicating that in non-conflicted situations, fiduciaries are liable only for actual fraud); Sec. Trust Co. v. Dabney, 372 S.W.2d 401, 406 (Ky. 1963) (“Absent fraud, actual or constructive, the courts will not interfere with the management of a private corporation.”); Taylor v. Axtion–Fischer Tobacco Co., 173 S.W.2d 377, 378 (Ky. 1943) (“It is fundamental and elemental that the action of directors when exercised in good faith and not in fraud of the rights of the stockholders is not subject to their control and will not be interfered with by the courts.”); Mfrs.’ Land & Improvement Co. v. Cleary, 89 S.W. 248, 249 (Ky. 1905) (“The judgment or discretion of the governing body, usually a board of directors, as to matters intra vires, is entirely beyond the control of the stockholders through the intervention of the courts, except for frauds committed or threatened against the corporation or the minority stockholders.”). All the foregoing suggests, incorrectly under today's law, that managers are liable only for fraud.

144 Although monitoring is normally considered in regard to directors' obligation to monitor senior officers, senior officers, in turn, also have a duty to monitor junior officers and employees. In the old case of Bates v. Dresser, 251 U.S. 524 (1920), for example, Dresser, the president of a bank, was held to have failed in his duty to monitor an employee, Coleman, who embezzled $310,143 from the bank. Average deposits for the bank were only $300,000. See id.
obligations have recently received intense scrutiny in the wake of massive corporate failures such as those of Enron and WorldCom.  

1. The Law Generally

Corporate managers are typically held to a reasonable person standard with regard to their obligation to monitor the affairs of the corporation. The business judgment rule, with its relaxed standards, is applied only with regard to discrete decisions made by corporate managers. A comment to the Principles of Corporate Governance states: “There is . . . no reason to provide special protection [for corporate fiduciaries] where no business decisionmaking is to be found. If . . . directors have failed to oversee the conduct of the corporation’s business[,] . . . business judgment rule protection [for directors] would be manifestly undesirable.”

Francis v. United Jersey Bank is a good example of a monitoring case. Lillian G. Prichard was a director of a company from which her sons, who were senior officers in the company, misappropriated a large amount of money. In evaluating whether Mrs. Prichard had fulfilled her monitoring duties to the corporation, the court applied a negligence standard. The court concluded that she had not performed at a reasonable level, notwithstanding that she was old, unsophisticated, physically incapacitated and had “started to drink rather heavily.” The court found that she “knew virtually nothing” about the company’s business, “visited the corporate officers . . . on only one occasion,” “never read or obtained the annual financial statements,” was “unfamiliar with the rudiments” of the company’s

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145 While the focus of this paper is on state-law fiduciary duties, the national stock exchanges and the Nasdaq have emerged as significant rule makers respecting the obligation of directors to act as meaningful monitors on the conduct of corporate managers. See, e.g., The NASDAQ Stock Market, Inc. Marketplace Rule 4350(c) (April 15, 2004), available at http://www.nasdaq.com/about/corporategovernance.pdf (listing standards requiring 1) a majority of the directors to be independent; 2) CEO compensation to be recommended or determined by a majority of independent directors or an independent compensation committee; and 3) director nominees to be recommended or determined by a majority of independent directors or an independent nominating committee).

146 See, e.g., PRINCIPLES OF CORP. GOVERNANCE § 4.01(a) (“A director or officer has a duty . . . [to act in a way] that he or she reasonably believes to be in the best interests of the corporation.”) (emphasis added).

147 Id. § 4.01(c) cmt. c. In the famous Delaware case Aronson v. Lewis, 473 A.2d 805, 813 (Del. 1984), the court stated that “the business judgment rule operates only in the context of director action . . . [I]t has no role where directors have either abdicated their functions, or absent conscious decision, failed to act.” Id.


149 Id. at 819–20.
business, and "made no effort to assure that policies of the corporation... pertaining to withdrawal of funds[...] complied with industry custom or relevant law."\textsuperscript{151} In short, the court found that she "did not pay any attention to her duties as a director or to the affairs of the corporation." These facts led the court to conclude that she failed to meet her duty to monitor reasonably.\textsuperscript{152}

2. Kentucky Law

Although Kentucky case law is thin, it offers at least modest support for imposing a higher standard of care in monitoring cases than in cases involving discrete actions by fiduciaries.\textsuperscript{153} Somewhat surprisingly, Kentucky's business judgment statutes\textsuperscript{154} also support a higher, pure negligence standard with regard to the monitoring obligations of fiduciaries in Kentucky corporations. A close reading suggests that the reasonable inquiry obligation required by those Kentucky statutes is applicable both to the monitoring function and to discrete decisionmaking cases, while the more relaxed "honestly believes" standard is available only at the discrete decisionmaking stage.

Considering the language more specifically, the Kentucky statutes require a corporate fiduciary in "the discharge of his duties" to act "[o]n an informed basis."\textsuperscript{155} Since these "duties" include both monitoring and discrete decisionmaking, the obligation to act on an "informed basis" would seem to apply to both aspects of the fiduciaries' duties. The statutes then define "informed basis" as requiring a reasonable "inquiry into the business and affairs of the corporation or into a particular action to be taken . . . ."\textsuperscript{156} Once again, the first part of that language—the duty to make reasonable

\textsuperscript{151} Id. at 819.
\textsuperscript{152} Id. Another example of a culpable failure to monitor can be found in the Principles of Corporate Governance: "[A] director received but did not read basic financial information over a period of time, and thus allowed his corporation to be looted." PRINCIPLES OF CORP. GOVERNANCE § 4.01(c) cmt. c (1992).
\textsuperscript{153} In Levitan v. Stout, 97 F. Supp. 105 (W.D. Ky. 1951), a federal court applying Kentucky law articulated an exceedingly lax fiduciary standard applying to actions of directors, but then recognized that directors also have been held liable for "losses resulting from their lack of attention to its affairs." Id. at 116. This seems to recognize the distinction between monitoring and discrete decisionmaking and at least to suggest a more rigorous standard for monitoring.
\textsuperscript{154} K.R.S. § 271B.8-300 (Banks–Baldwin 2004) (defining the duties of directors); § 271B.8-420 (defining the duties of corporate officers). The language of these statutes is identical.
\textsuperscript{155} §§ 271B.8-300(1), .8-420(1).
\textsuperscript{156} §§ 271B.8-300(2), .8-420(2).
“inquiry into the business and affairs of the corporation”—appears to be aimed directly at the monitoring function.

If, therefore, one takes this language and imagines a Kentucky case similar to *Francis*—a case in which a director’s negligent inattention enabled officers to loot and steal from the corporation—the language of the Kentucky statutes suggests that directors would have violated their fiduciary duty under Kentucky law, even if such monitoring were not so poor as to amount to gross negligence.

One should expect that Kentucky courts will confirm a strict reasonable person standard for managers’ monitoring obligations. As I write, the landscape is littered with companies that failed in part due to poor monitoring. While federal rule makers have responded with laws and regulations—such as the Sarbanes-Oxley Act, Securities and Exchange Commission regulations implementing Sarbanes-Oxley, and enhanced listing standards from the national securities exchanges and Nasdaq—state corporate fiduciary standards are still important vehicles for ensuring that corporate fiduciaries live up to society’s expectations. It thus seems unlikely that Kentucky courts would be inclined to compromise a strict standard regarding this most important fiduciary function.

IV. PARTICULAR FIDUCIARY DUTY ISSUES UNDER KENTUCKY LAW

A. Disclosure Obligations

Accurate information is essential to the creation of economic wealth. In the case of corporate decisionmakers, they must have accurate and timely information to make wealth-maximizing decisions and to fulfill their monitoring functions. Senior officers typically control the flow of information to directors and shareholders. It is important, therefore, that society’s rules provide economic incentives for corporate officers and managers to make appropriate disclosures of material corporate information.

The obligation of corporate fiduciaries to disclose important information may seem primarily to implicate the antifraud provisions of securities laws. Most apparent in that regard is Rule 10b–5 under the Securities Exchange Act of 1934, which prohibits manipulation or


\[159\] See, e.g., NASDAQ Marketplace Rule 4350(c), supra note 145.
deception in connection with the purchase or sale of securities. A disclosure obligation, however, is also an integral part of managers' fiduciary duties.

Kentucky cases involving corporate fiduciary decisions properly promulgate a strong version of the duty of corporate managers to disclose information to boards of directors and shareholders. Language suggests that the adequacy of disclosure will be measured under Kentucky's fiduciary principles by a standard similar to the "materiality" standard used in federal securities cases, and that courts will take an expansive view of what is included in the materiality standard. Kentucky's highest court, for example, has spoken of the "duty to fully disclose" and declared that a fiduciary "must lay bare the truth without ambiguity or reservation, in all its stark significance."

Considering, first, situations involving discrete corporate decisions that are made either by directors or shareholders, Kentucky cases make clear that managers who provide materially inaccurate or incomplete information in connection with such discrete decisions violate their fiduciary obligations. Brewer v. Lincoln International Corp. is an example of such a case. There, the plaintiffs, who were shareholders, alleged that managers failed to disclose the value of the company's principal assets in connection with an amendment to the company's articles of incorporation. Following the amendment, plaintiffs were frozen out of the corporation at what was alleged to be an unfairly low price. Essentially, the claim was that, if the plaintiffs had known about the real value of the company's assets, they would not have agreed to the amendment to the company's articles. This, the court found, stated a valid claim for a breach of fiduciary duty.

\[1^{60} 17 C.F.R. § 240.10b-5 (2004).\]
\[1^{61} In a case involving co-tenants, a Kentucky court concluded that a fiduciary duty was owed and that "such a relation imposes a duty to disclose material facts affecting that interest." Foley v. Smith, No. 2003–CA–000621–MR, 2004 WL 1102335, at *1 (Ky. Ct. App. May 14, 2004) (emphasis added).\]
\[1^{62} See TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 439 (1976) ("An omitted fact in a proxy solicitation is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote.").\]
\[1^{63} Aero Drapery of Kentucky, Inc. v. Engdahl, 507 S.W.2d 166, 169 (Ky. 1974).\]
\[1^{64} Brewer v. Lincoln Int'l Corp., 148 F. Supp. 2d 792 (W.D. Ky. 2000).\]
\[1^{65} See id. at 813; see also Foley, 2004 WL 1102335. Although Foley involved joint owners of real property, it supports the conclusion that a fiduciary duty requires disclosure with respect to discrete decisions. The court found that co-tenants of real property owe one another fiduciary duties. The co-tenants agreed to sell their jointly owned property to a corporation controlled by one of the co-tenants, Smith. The other co-tenant, Foley, worked for Smith's corporation and was fired after the sale of the jointly owned property was completed. Foley later complained that he would not have agreed to the sale if he had known that Smith was going to fire him and that Smith, as his fiduciary, owed him (Foley) the duty\]
While there is nothing remarkable about a case like Brewer (and certainly one would be surprised by a contrary outcome) the general rule that fiduciaries are obligated to provide accurate and complete information when corporate decisionmakers make discrete decisions is a very important prophylactic. The rule provides an incentive to supply information necessary for economically efficient decisions by boards of directors and shareholders. To avoid violations of their fiduciary duties and any resulting personal civil liability, senior managers have an economic incentive to furnish boards with accurate, complete information, and boards have an economic incentive to supply shareholders with the same.

This may have an especially broad impact on companies that are not reporting under the Securities Exchange Act of 1934. For example, the failure of the board of a non-1934 Act company to disclose materially negative information about a board nominee in its annual proxy solicitation could violate the board’s fiduciary duty to shareholders. Similarly, any misstatement in the unaudited monthly financial information supplied by the chief financial officer and the chief executive officer to the company’s board also could violate the fiduciary duties of those officers. Properly understood, therefore, Kentucky’s strong version of the fiduciary duty of disclosure can provide an economic incentive for improved corporate decisionmaking.

In addition to making discrete decisions, both corporate boards of directors and shareholders perform monitoring functions in the corporate governance structure. Kentucky cases confirm a fiduciary duty on the part of managers to provide corporate decisionmakers with the material information necessary for them to perform their monitoring duties.

In Innes v. Howell Corp., the Sixth Circuit concluded that a vice president of a Kentucky corporation was “a fiduciary” and thus “was required to disclose to the corporation any conflicts of interest” in connection with transactions he undertook on behalf of the corporation. In Aero Drapery of Kentucky, Inc. v. Engdahl, a fiduciary set up a business in competition with his corporation. The court concluded that “it [was] . . . his duty to fully disclose these facts to the corporation,” in large

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166 There are several exemptions to the reporting requirements of the Securities Exchange Act of 1934, the most common of which are that companies with assets of less than ten million dollars or 500 shareholders of record need not register with the SEC. See, e.g., 17 C.F.R. § 240.12g-1 (2005).
168 See id. at 715.
169 Aero Drapery of Kentucky, Inc. v. Engdahl, 507 S.W.2d 166, 166 (Ky. 1974).
part because he "knew of a forthcoming, simultaneous loss of key employees." Innes and Aero Drapery are considered monitoring cases. In each, the fiduciary violated a duty to supply the board with material information necessary to monitor the conflicted situation in which the fiduciary had placed himself. Conflicts, of course, are especially sensitive situations and require intensified monitoring on behalf of the corporation.

Kentucky courts appropriately conclude that information flows are important to efficient, well-run corporations. Because senior managers control, to a very large degree, the information flows coming to the corporate decisionmakers and monitors, Kentucky's expansive view of "materiality" and its willingness to enforce a strong disclosure duty amount to important weapons against corporate abuses. Kentucky courts rightly conclude that managers must be made to feel the potential economic sting of disclose failures.

B. Competition with the Corporation

A corporate fiduciary's competition with her corporation raises difficult economic and policy issues. On the one hand, a fiduciary who opens a new business that competes with her company increases competition in the product market, which generally is thought to be beneficial. On the other hand, the threat of fiduciary competition makes corporations reluctant to transfer information to the fiduciaries and reluctant to make human capital investments (training, for example) in their top managers. Without information transfers and human capital investment, the corporation is less efficient. Optimal rules respecting competition with the corporation, therefore, must accommodate these competing economic and policy concerns.

Under Kentucky common law, corporate fiduciaries who engage in direct, active competition with their corporation violate their fiduciary duties unless a proper and unbiased corporate decisionmaker with knowledge of all material facts waives the conflict. Aero Drapery and

\[170\] Id. at 169.

\[171\] For example, stiff competition forces inefficient competitors out of the product market and redeploy their assets into other areas.

\[172\] The natural fear, if the fiduciary is permitted the unfettered right to compete with her corporation, is that the fiduciary will use the information in a new competitive business, which will be harmful to the corporation.

\[173\] The fear is that the fiduciary will take her newly acquired human capital and use it in a competitive corporation.

\[174\] Aero Drapery of Kentucky, Inc. v. Engdahl, 507 S.W.2d 166 (Ky. 1974).
Steelvest, Inc. v. Scansteel Service Center, Inc.\textsuperscript{175} are the leading cases in this area, and each states a strong version of the general duty on the part of corporate fiduciaries to avoid such conflicts. In Aero Drapery, the court stated that corporate fiduciaries "cannot, while still a corporate fiduciary, set up a competitive enterprise,"\textsuperscript{176} and in Steelvest the court stated that "directors and officers . . . may not set up . . . an enterprise which is competitive with the business in which the corporation is engaged while still serving as directors and officers."\textsuperscript{177}

The court in Aero Drapery also makes it clear that the corporation is permitted to waive any competition conflict with its fiduciary. The court, in considering whether the corporate fiduciary, Engdahl, had violated his fiduciary duty to his corporation, stated that Engdahl's "fiduciary position obligated him not to develop [conflicting business] interests . . . without full disclosure."\textsuperscript{178} This approach on the part of Kentucky courts is sound. It essentially leaves it to the parties—the fiduciary and the corporation—to work out the terms of their arrangements in a manner that suits themselves. Effectively, however, it establishes a presumption that the parties generally would agree to prohibit the fiduciary from engaging in direct competition with the corporation.\textsuperscript{179} Competition is permitted only if there is a showing that the parties agreed to waive the general rule. Since there are no significant externalities or third-party effects upon the arrangement between the manager and her corporation,\textsuperscript{180} it seems entirely appropriate...

\textsuperscript{175} Steelvest, Inc. v. Scansteel Serv. Ctr., Inc., 807 S.W.2d 476 (Ky. 1991).
\textsuperscript{176} Aero Drapery, 507 S.W.2d at 169.
\textsuperscript{177} Steelvest, 807 S.W.2d at 483.
\textsuperscript{178} Aero Drapery, 507 S.W.2d at 169 (emphasis added).
\textsuperscript{179} Once it is recognized that the parties have the right to construct their own arrangements, the matter becomes a classic gap filling exercise for the court. See POSNER, supra note 113, at 93–98. "The task for a court asked to interpret a contract to cover a contingency that the parties did not provide for is to imagine how the parties would have provided for it had they thought to do so." Id. at 96. The court in Steelvest recognized its role as that of filling in gaps in the absence of an agreement between the fiduciary and the corporation regarding the fiduciary's right to compete. The court states that "a corporation officer or other higher-echelon employee is barred from actively competing with his or her employer during the tenure of the employment, even in the absence of an express covenant so providing." Steelvest, 807 S.W.2d at 484 (emphasis added).
\textsuperscript{180} One might argue that society is harmed if the private arrangements between the company and the fiduciary impede competition. Such harm seems unlikely and is offset by other efficiency gains. See supra note 154 and accompanying text. Further, the antitrust laws are available to provide remedies for harmful anticompetitive contracts. In short, any material third party effects from allowing the corporation and the fiduciary to work out their own arrangements regarding the matter of competition seem highly speculative.
to allow them to work out the terms of their arrangement and to employ this efficient presumption when their preferences are not made explicit.\textsuperscript{181}

While Kentucky courts are clear and on sound ground regarding these general rules, tough questions arise in connection with specific applications of the rules. For example, Kentucky courts have considered the extent to which a corporate fiduciary may make preparations to compete with his corporation while continuing in his fiduciary position with the corporation.

Although it is difficult to articulate the precise point at which such preparations violate a manager’s fiduciary duty to his corporation, Kentucky cases suggest that the point occurs early in the preparation process. In \textit{Aero Drapery}, the court stated that the corporate fiduciary should have resigned from the corporation “when he first began preparation to directly compete with” the corporation.\textsuperscript{182} The court used essentially the same language in \textit{Steelvest}, stating that corporate fiduciaries “should terminate their position . . . when they first make arrangements or begin preparations to compete directly with the . . . corporation.”\textsuperscript{183}

Part of the problem with articulating a more precise rule than one finds in \textit{Aero Drapery} or \textit{Steelvest} is that the amount and sequencing of the fiduciary’s preparation steps will inevitably vary from case to case. Nonetheless, one might imagine a typical preparation sequence in which the fiduciary gets the idea of opening a competing business and then goes about preparations, which might include: personal research into the matter; seeking professional legal, accounting, and tax advice; arranging for financing and investors; soliciting customers; and acquiring property and the necessary managers and work force. In this sequence, the general language from \textit{Aero Drapery}\textsuperscript{184} and \textit{Steelvest}\textsuperscript{185} suggest that anything beyond one’s personal research into the matter violates the duty not to compete with the corporation.

It is sensible for Kentucky courts to apply a strict standard here and to find that the duty of fiduciaries not to compete with their corporation attaches early in the preparation process. Disclosure and waiver of the conflict is a defense under Kentucky law to this potential breach of the duty of loyalty; for this reason, managers should be encouraged early in the process to disclose their competitive activities to their corporations.

\textsuperscript{181} This presumption—that the parties most likely would not permit such competition—is efficient because it most likely approximates the arrangement that most parties would come to in most cases. See supra notes 6–7 and accompanying text.
\textsuperscript{182} \textit{Aero Drapery}, 507 S.W.2d at 169.
\textsuperscript{183} \textit{Steelvest}, 807 S.W.2d at 483.
\textsuperscript{184} See supra note 163 and accompanying text.
\textsuperscript{185} See supra note 164 and accompanying text.
Another difficult issue for Kentucky courts is the question of whether there are any limitations on what the fiduciary can do once he has resigned and begun his new business in competition with his old corporation. In his new business, can the former fiduciary, for example, compete vigorously with his old corporation for customers, supplies, and employees? The language from Kentucky cases suggests a wide latitude for former fiduciaries competing with their old corporations. \(^{186}\) Even after a proper resignation, however, former managers can get themselves into trouble by exploiting advantages improperly obtained while fiduciaries of the corporation.

In Steelvest, for example, one part of the complaint was that the fiduciary stole away employees for his new, competing company. Evidence in the case, however, indicated that the fiduciary, prior to resignation, had convinced some employees to leave the company for the fiduciary’s new, competing enterprise. \(^{187}\) Similarly, in Aero Drapery \(^{188}\) the fiduciary provided his new, competing company with forms and charts from his prior corporation. Again, while the use of those items occurred after the resignation of the fiduciary, they were taken during the fiduciary’s tenure with the corporation. \(^{189}\) In both cases, therefore, the former fiduciary was found to have breached a duty to his prior corporation by exploiting advantages unfairly obtained while he was a manager of the prior corporation.

To illuminate the distinction between permissible and impermissible conduct, consider Steelvest, where the fiduciary breached his duty before leaving the company by competing for the company’s employees. It seems apparent that, had the fiduciary waited until after he had severed his relationship with his old company, he would then have been entirely free to attempt to hire employees from his former company and otherwise to compete with his old company in all areas.

\(^{186}\) See Aero Drapery, 507 S.W.2d at 169 (holding that, after resignation, a former fiduciary, “[u]nless bound by contract,” is able to enter into or create “a competing enterprise”).

\(^{187}\) The court in Steelvest stated:

There is also some evidence of record that prior to his resignation from Steelvest, Scanlan indicated to prospective investors and to bank personnel that he would bring with him some of the present employees of Steelvest. Just coincidentally/inferentially, ... shortly after Scanlan resigned from Steelvest, nine office and supervisory employees left the company to work for Scansteel.

Steelvest, 807 S.W.2d at 484.

\(^{188}\) Aero Drapery, 507 S.W.2d at 166.

\(^{189}\) Id. at 168 (“Prior to their resignations, [the fiduciaries] ... copied virtually every form and chart used in Aero’s business.”).
Another duty that follows the fiduciary into the new business is the duty to maintain corporate confidences. The fiduciary in *Aero Drapery* twice violated this duty. First, as described above, the fiduciary disclosed the company's confidential forms and charts. Second, the fiduciary disclosed the terms of the company's "confidential stock bonus plan." The court indicated a significant breadth to the confidentially obligation that continues even after resignation, stating that even after resignation a fiduciary "may not use prior fiducial confidences to profit at the expense of his former employer."

In Kentucky, therefore, except for the duty not to exploit prior breaches of fiduciary duties and the duty to maintain corporate confidences, former fiduciaries who have properly terminated their relationship with their corporations seem free to enter into fair and vigorous competition with their former corporation.

**C. Acquisitions**

1. *Overview Regarding the Application of Fiduciary Duties in Corporate Acquisitions*

In cases arising from corporate acquisitions, one should expect that Kentucky courts will apply the broad fiduciary principles described in Section III of this article. That is, Kentucky courts seem likely to apply a business judgment standard to non-conflicted acquisitions, the intrinsic fairness standard to deeply conflicted acquisitions, and the proportionality test to quasi-conflicted acquisitions.

A number of specific issues involving acquisitions have arisen in Kentucky courts. The following sections discuss the most important of these acquisition issues. Regrettably, some of these decisions point courts in the wrong direction with regard to the application of Kentucky's fiduciary standards to corporate acquisitions but, fortunately, none of these misapplications has yet been approved by the Kentucky Supreme Court.

2. *Freezeouts and the Business Purpose Doctrine*

In a freezeout, majority shareholders, by exercising their raw power to control the corporation, force minority shareholders to surrender their

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190 See id. at 169.
191 See id.
192 Id. at 170.
corporate stock in exchange for cash. Some, but not all, courts apply the business purpose doctrine to such freezeouts. Under that doctrine, a freezeout violates the fiduciary duties owed to minority shareholders if the freezeout "serves no business purposes other than the termination of the minority stockholder's interest." The freezeout must, therefore, further some "legitimate corporate purpose."

So defined, the business purpose doctrine only protects against acquisitions that do not generate efficiencies or savings for the surviving business. The doctrine itself does not protect against freezeouts that unfairly expropriate value from shareholders. Standing alone, therefore, the business purpose doctrine would permit a freezeout that is unfair to minority shareholders so long as the surviving corporation captured some savings or efficiencies as a result of the transaction.

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195 In Berkowitz, the court defined the test as not being met if the freezeout "serves no business purpose other than the termination of the minority stockholder's interest." Berkowitz, 342 A.2d at 573 (citing and rejecting the approach of Bryan v. Brock & Blevins Co., 490 F.2d 563 (5th Cir. 1974)).

196 Coggins, 492 N.E.2d at 1118 (emphasis added).

197 Easterbrook and Fischel list the following gains that may result from a freezeout of minority shareholders: "economies of scale, centralized management and corporate planning, . . . economies of information"; a lower "cost of policing conflicts of interest"; improved ability "to make additional cost-justified investments"; "lower agency costs"; eliminating
Courts that use the business purpose doctrine apply it in addition to, and not in lieu of, the intrinsic fairness test. This means that in states that accept the business purpose doctrine, the freezeout must meet the intrinsic fairness test (fair dealing and fair price) and also must generate some benefit for the surviving corporation as a whole. A failure to meet either amounts to a violation of fiduciary duties.

In Yeager v. Paul Semonin Co., the Kentucky Court of Appeals rejected the business purpose test. The case was brought by a minority shareholder who was frozen out of his corporation in a statutory merger and claimed that the merger's "whole purpose was to eliminate . . . minority stockholders." In finding against the plaintiff, the Court of Appeals reasoned that the plain language of the Kentucky statutes permits mergers for any purpose (including the purpose of freezing out minority shareholders) and that appraisal offered an approved and fair remedy for such disgruntled shareholders.

Although it is a close call, the outcome in Yeager is probably sound. The business purpose doctrine offers no meaningful additional protection to minority shareholders, nor does it improve economic efficiency. Applying the doctrine does, however, at least marginally increase the transactional costs of moving assets into more efficient hands.

As a way of demonstrating that the business purpose doctrine offers no meaningful protection to minority shareholders, consider the following examples. First, assume that, before a freezeout occurs, the total value of a corporation is $100, the value of the majority's stock is $60, and the value of the minority's stock is $40. As a result of the freezeout, efficiency gains the total value to $120, but decreases the value of the minority shareholders' interest to $30.

This transaction does not violate the business purpose doctrine. Even though minority shareholders were harmed economically by the freezeout, the benefit to the "corporation," demonstrated by the increase in the firm's value, satisfies the requirement of a "business purpose." Also important for this discussion, however, is the point that the transaction would likely...
violate the intrinsic fairness test, since $30 would not amount to a "fair price" for the frozen out minority shareholders.203

Now consider a purely expropriative merger. Assume the same pre-freezeout numbers—$100 in total value, with $60 in value for majority and $40 for minority. Assume that the minority shareholders are frozen out at the unfairly low price of $30 per share, but that there are no efficiency gains from the freezeout. The post-freezeout value of the corporation, therefore, stays at $100. The transaction, in short, is driven solely by the majority’s desire to expropriate part of the minority’s value, thus clearly violating the business purpose test. In all likelihood, however, the transaction would also violate the intrinsic fairness standard, since $30 does not amount to a fair price.204 Even in the case of a purely expropriative freezeout—which is the only instance in which the business purpose doctrine is applicable—the business purpose doctrine adds no beneficial protection to the interests of the minority; they are equally well protected by the applicability of the intrinsic fairness doctrine.

It is hard to see, therefore, how the business purpose doctrine helps minority shareholders. This conclusion is even more vivid when one considers the ease with which the majority is able to demonstrate some efficiency or gain from the freezeout. It is hard to imagine many transactions in which the majority could not offer some evidence of efficiencies created by a freezeout. Indeed, elimination of SEC filing requirements, attainment of subchapter S tax status, and operational efficiencies come to mind easily as benefits that will satisfy the business purpose doctrine.205

Thus, the business purpose doctrine hardly seems worth the trouble, and Yeager is on sound ground in rejecting it.

3. The Exclusivity of Appraisal as a Remedy for Unhappy Shareholders

Another issue courts have considered in connection with acquisitions is the extent to which statutory appraisal is an exclusive remedy.206 Most typically, the issue has arisen in the context of an affiliated merger, where minority shareholders, who unquestionably have statutory appraisal rights,

203 In Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983), the Delaware Supreme Court held that a court must consider both fair dealing and fair price in evaluating whether a freezeout met the intrinsic fairness test. For a discussion of "fair price," see Rutherford B. Campbell, Jr., Fair Value and Fair Price in Corporate Acquisitions, 78 N.C. L. Rev. 101, 127–33 (1999) [hereinafter Campbell, Fair Value].
204 See supra note 119.
205 See supra note 195.
206 See COX & HAZEN, supra note 58, at 630–33.
may want to press their fiduciary claims under the intrinsic fairness doctrine.\textsuperscript{207}

The better position for Kentucky would be to consider appraisal as a non-exclusive remedy, giving shareholders the right to pursue a remedy for a breach of fiduciary duty, whether or not they may also have an appraisal remedy. The language of Kentucky’s appraisal statute supports this position. Allowing shareholders with appraisal rights to pursue remedies for breaches of fiduciary duties also promotes economic efficiency and fairness.

The Kentucky appraisal statute states that a “shareholder entitled to dissent . . . shall not challenge the corporate action . . . unless the action is unlawful or fraudulent.”\textsuperscript{208} “Unlawful” in Kentucky’s appraisal statute is not defined, but it appears to be a broad concept that includes more than just criminal violations.\textsuperscript{209} Thus, for example, a merger effected in violation of the statutorily required voting or quorum prerequisites\textsuperscript{210} would be

\textsuperscript{207} Weinberger, 457 A.2d 701, is an example of such a case. In Weinberger, UOP was merged into its parent, Signal. Minority shareholders of UOP, who were offered cash in the transaction, were entitled to appraisal rights but chose instead to pursue fiduciary claims against defendants that included Signal and the UOP board. See id.

\textsuperscript{208} K.R.S. § 271B.13-020(2) (Banks–Baldwin 2004). A similar standard was used in an earlier Kentucky case that was decided before the adoption of the most recent version of Kentucky’s corporate statutes. In Yeager v. Paul Semonin Co., 691 S.W.2d 227 (Ky. Ct. App. 1985), the Kentucky Court of Appeals concluded that, while generally appraisal is the exclusive remedy for shareholders unhappy with a merger, it would not infer “a legislative purpose to deny judicial relief in a merger situation where illegality or fraud are involved.” Id. at 228.

Corporate statutes typically address the matter of the exclusivity of appraisal. For example, the Model Business Corporation Act makes appraisal exclusive unless the transaction either “(1) was not effectuated in accordance with [the MBCA] . . . or the corporation’s articles of incorporation, bylaws or board of directors’ resolution authorizing the corporate action; or (2) was procured as a result of fraud or material misrepresentation.” MODEL BUS. CORP. ACT § 13.02(d) (1984). The Official Comment to the Model Business Corporation Act emphasizes that the provision applies only to “challenges . . . to the corporate action.” The comment states that “it does not address remedies, if any, that shareholders may have against directors or other persons as a result of the corporate action.” See id. cmt. 5.

Not all state statutes address the matter of exclusivity. See, e.g., DEL. CODE ANN. tit. 8, § 262 (2004). Delaware deals with the issue as a matter of common law. For a discussion of the development of the exclusivity rule, see Glassman v. Unocal Exploration Corp., 777 A.2d 242, 244–47 (Del. 2001).

\textsuperscript{209} “Unlawful,” the statutory term, and “illegal,” the term used in Yeager; 691 S.W. 2d at 228, seem interchangeable. For an overview of the manner in which courts have interpreted the terms “fraud” and “illegality” in the context of the matter of appraisal exclusivity, see COX & HAZEN, supra note 58, at 630–33.

\textsuperscript{210} Under Kentucky law, a merger must be approved by “a majority of all the votes entitled to be cast on the plan.” K.R.S. § 271B.11-030(5).
“unlawful,” even though the failure to obtain a proper vote or quorum would not be criminal. Similarly, a merger effected in violation of the directors’ fiduciary duty under Kentucky’s common law or business judgment statute\(^\text{211}\) should similarly be considered “unlawful.” Kentucky statutory law requires directors to adopt a resolution approving a merger and to “recommend” the merger to shareholders.\(^\text{212}\) If those directors’ actions are not undertaken on “an informed basis” or pursuant to an honest belief that the actions are in the best interests of the company, the actions are “unlawful” and thus outside the exclusivity of Kentucky’s appraisal statute.\(^\text{213}\)

This position—that appraisal rights do not exclude the right to pursue claims of a breach of fiduciary duties in mergers—is essentially the position at which the Delaware courts arrived over a period of years.\(^\text{214}\) In the Glassman case, the Delaware Supreme Court summed up the Delaware rule by stating that Delaware cases “effectively eliminated appraisal as the exclusive remedy for any claim alleging breach of the duty of entire fairness.”\(^\text{215}\)

Allowing shareholders of Kentucky corporations to pursue appraisal remedies and remedies for breaches of fiduciary duties is sound policy since it reduces incentives for managers and controlling shareholders of companies to undermanage the company as part of a strategy to expropriate shareholder value. Shareholders pursuing a fiduciary remedy are thought to have a greater right to share the synergy generated by a merger than they have in an appraisal proceeding. Under Kentucky law, for example, the only appraisal remedy for dissenting shareholders in mergers is the right to “obtain payment of the fair value of his shares,”\(^\text{216}\) and the amount of the

\(^{211}\) See § 271B.8-300.

\(^{212}\) See § 271B.11-030(1)-(2).

\(^{213}\) The legal obligations of directors under Kentucky’s business judgment statute include the obligation to consider the merger in “good faith,” on “an informed basis,” and “[i]n a manner he honestly believes to be in the best interests of the corporation.” § 271B.8-300(1).


\(^{215}\) Id. at 247. The Glassman court, relying on the earlier case of Rabkin v. Philip A. Hunt Chemical Corp., 498 A.2d 1009 (Del. 1985), noted that “appraisal is the exclusive remedy only if stockholders’ complaints are limited to judgmental factors of valuation.” Glassman, 777 A.2d at 247 (internal citations omitted). The court continued: “Rabkin, through its interpretation of Weinberger, effectively eliminated appraisal as the exclusive remedy for any claim alleging breach of the duty of entire fairness.” Id. In Glassman, however, the Delaware court held that there is no duty “to establish entire fairness” in a short form merger. Id. at 248. Effectively, therefore, this holding makes appraisal the exclusive remedy for shareholders of Delaware companies that engage in short form mergers.

\(^{216}\) See K.R.S. § 271B.13-020(1).
“payment”—which is inevitably cash—excludes “appreciation or depreciation in anticipation of the corporate action.” Where disgruntled shareholders in an acquisition are able to pursue fiduciary duty remedies, however, courts are much more willing to award damages that include their proportionate share of the synergistic gain from the transaction.

Consider how a rational control shareholder might act in a regime in which appraisal does not include a proportionate share of the synergy generated by a merger, but appraisal is the exclusive remedy for a shareholder. Imagine a situation like Weinberger, where Parent owns a majority of Subsidiary. Assume that the minority shareholders’ interest in Subsidiary is worth $100 if Subsidiary is well managed, but worth only $80 if Subsidiary is poorly managed. If appraisal is the exclusive remedy for disgruntled shareholders, Parent, with help from its nominees in Subsidiary’s management, seemingly can generate monetary gain for itself by causing Subsidiary to be undermanaged, thus driving down the market value of Subsidiary to $80. If Parent then freezes out the minority, Parent may reasonably anticipate that the minority’s appraisal right would be valued at $80, instead of $100, since the $20 difference looks like “synergy” that is generated by moving the assets of Subsidiary into more efficient hands. Parent, therefore, under a regime that makes appraisal exclusive, has a financial incentive to undermanage Subsidiary’s assets; this is an inefficient result.

218 § 271B.13-010(3). The statute permits the inclusion of appreciation in “fair value” if “exclusion [of appreciation] would be inequitable.” Id. In a prior article, I found that courts may be willing to award dissenting shareholders some portion of the gains from acquisitions, notwithstanding the type of language recited by courts in the text of this article. See Campbell, Fair Value, supra note 203, at 116–27.

221 Although articulating the matter in somewhat confusing language, the court in Weinberger authorized “rescissory damages” in cases involving breaches of the duty of intrinsic fairness. See Weinberger v. UOP, Inc., 457 A.2d 701, 714 (Del. 1983). Rescissory damages award the successful plaintiff an amount equal to the gains of the wrongdoer–defendant. See, e.g., Lynch v. Vickers Energy Corp., 429 A.2d 497 (Del. 1981) (measuring the damage to a target corporation’s shareholders by the increment in value to the bidder). Rescissory damages, therefore, allow the plaintiff to recover the synergy created by the transaction.

For an extensive discussion of the valuation of dissenting shareholders’ appraisal rights (fair value) and the valuation of claims involving breaches of fiduciary duties in acquisitions (fair price), see Campbell, Fair Value, supra note 203, at 116–34. The right of dissenting shareholders in appraisal proceedings to a proportionate share of synergy is discussed, id. at 122–27; the rights of shareholders to share pro rata in synergy through a fiduciary duty proceeding is also discussed, id. at 129–33.

222 Probably one of the most egregious examples of this is the case involving the freezeout of the minority shareholders of the Kirby Lumber Corporation. See Santa Fe Indus., Inc. v. Green, 430 U.S. 462 (1977).
If, on the other hand, the intrinsic fairness standard were also available to minority shareholders of Subsidiary, they would have a better chance of securing their proportionate share of the $20 in "synergy." This in turn lessens the incentive for Parent to engage in inefficient conduct by undermanaging Subsidiary.

This matter can be restated in terms of the unfairness to Subsidiary's minority shareholders. When shareholders invest in a company, they are entitled to assume that managers will pursue their best interests. That assumption—which is backed up by the law of corporate fiduciary duties—is impounded in the price shareholders pay for their shares. As a simple demonstration of this point, consider the likely impact on the price of a company's stock if management suddenly announced that they were no longer going to act in the best interests of shareholders. One would assume that the price of that stock would immediately drop in value.

Rules that protect against undermanagement, therefore, protect the *ex ante* expectations and pricing of shareholders. Shareholders determine the price they are willing to pay for stock based on assumptions about how managers will act. Thus, to allow managers to vary from the agreed-upon assumptions is not only economically inefficient but also unfair to shareholders and investors.

4. Calculating Present Value in Acquisitions

In *Ford v. Courier-Journal Job Printing Co.*, the Kentucky Court of Appeals applied a marketability discount to the valuation of dissenters' shares and also determined the present value of dissenters' rights by using a weighted average valuation method. Both of these holdings point Kentucky in the wrong direction concerning important shareholder rights. The misdirection may be largely due to the fact that *Ford* was decided over 20 years ago, before courts collectively gained substantial experience in acquisition cases and an appreciation for the economic realities in play when acquisitions occur. Kentucky should follow the lead of its progressive sister states and reverse its position on both of these important matters.

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224 The most recent version of the Model Business Corporation Act, for example, explicitly rejects the application of either a minority or marketability discount in the calculation of fair value in appraisals. MODEL BUS. CORP. ACT § 13.01(4)(iii) (1984) ("[F]air value means the value of the corporation's shares determined . . . without discounting for a lack of marketability or minority status.").
a. Minority and Marketability Discounts

A company that is the subject of an appraisal proceeding may claim that the dissenting shareholders' award should be reduced by a marketability discount and also perhaps by a minority discount. A marketability discount may be applied when the stock that is the subject of the appraisal is not actively traded. The claim supporting this discount is that company shares that have no active, efficient trading market are worth less than shares in an identical company that are traded in an active, efficient market. A minority discount, on the other hand, may be applied in a situation in which the dissenting shareholders hold a minority interest in a company that is controlled by a single shareholder or a cohesive block of shareholders. Once again, the claim is that the market will discount such minority shares.

The Kentucky Court of Appeals in Ford was presented the issue of whether to apply a marketability discount when determining appraisal value. An appraiser appointed by the lower court had applied a twenty-five percent marketability discount to the fair value of the dissenters' shares, which the lower court accepted. The Court of Appeals agreed with the lower court and thus applied the twenty-five percent marketability discount to the fair value of the dissenters' shares. The court in Ford was not asked to consider a minority discount to the fair value of the dissenters' shares. No other case in Kentucky has ever considered the matter of a minority discount.

Applying a marketability or minority discount to fair value is bad economics and encourages unfair treatment of shareholders. In many instances, it provides an incentive for controlling stockholders to engage in inefficient conduct that reduces shareholder value and facilitates unwarranted wealth transfers to themselves at the expense of minority shareholders. This is easily illustrated in the context of minority discounts.

Commentators have properly observed that an efficient market may discount a company's minority shares when there is an identifiable,

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225 This discount is a corollary of the notion that a control block of stock will command a "control premium" when it is sold. Both notions are based on the power of a majority to expropriate for itself a disproportionate portion of the company's value. See supra notes 212-14 and accompanying text.

226 Ford, 639 S.W.2d at 553. Although Ford was decided under a prior version of Kentucky's corporate law, Kentucky's present appraisal statute also allows the court in its discretion to appoint an appraiser to advise the court in appraisal cases. K.R.S. § 271B.13-300(4) (Banks-Baldwin 2004).

227 See Ford, 639 S.W.2d at 556.
controlling shareholder.\footnote{228} One reason for this minority discount is that the market fears the majority will expropriate a disproportionate share of the company’s value. There are various ways this can be accomplished. In a closely held corporation (or even a larger corporation), for example, the controlling shareholders can pay themselves and their affiliates overly generous salaries and consulting fees, or cause the company to purchase supplies and services from themselves or their affiliates at overly generous prices. Perhaps the most notorious way for a majority to acquire a disproportionate amount of the corporate value is to freeze out the minority at a low price.\footnote{229} Thus, in anticipation of such transactions, the efficient market reduces the price of the minority shares. Because the market prices stock as a function of anticipated cash flows and the market fears that the majority will expropriate a disproportionate share of the company’s future cash flows for itself, securities traders rationally discount the value of the minority’s shares.

To allow a majority shareholder (in a freezeout transaction, for example) to acquire the minority interest without having to pay the minority discount allows the majority shareholder to profit from unfair and inefficient conduct. It creates an incentive for an economically rational acquirer to obtain fifty-one percent of a company and then to drive down the price of the company’s stock by undermanaging the company or expropriating minority shareholders’ value or by threatening such undermanagement or expropriation.\footnote{230}


\footnote{230} Putting some simple numbers on this example may make the point clearer. Assume that prior to the acquisition of a control block, a company has 100 shares of common stock outstanding, each of which is selling in the efficient market for $10. The assumed total value of the company’s outstanding stock is $1000. The aggressor acquires 51 of the shares. We might then assume that the efficient market, for the reasons discussed in the text, discounts the 49 shares representing the minority interest from the prior price of $10 per share to a price of $8 per share. Thus, the total value of that minority interest decreased from $490 (49 shares at $10 per share) to $392 (49 shares at $8 per share). Allowing fair value to be determined with the minority discount means that the minority suffered a loss of $98 ($490 − $392) as a result of the mismanagement and expropriation threat of the aggressor. Legal rules should not permit one to capitalize on such threats; it is both inefficient and unfair.
While perhaps less vividly apparent, a similar analysis supports rejection of any marketability discount, contrary to the position taken by the Kentucky Court of Appeals in the *Ford* case.

Corporate managers owe a duty to maximize the wealth of their shareholders. One important way of doing this is for managers to minimize the transaction costs that shareholders encounter when buying and selling the company’s stock. If, on the other hand, managers’ actions increase trading costs by disrupting economical trading arrangements or failing to facilitate the creation of efficient trading markets, the value of the company’s shares falls and shareholder wealth decreases.

Allowing a marketability discount in fair value in an appraisal proceeding allows a controlling shareholder to generate gain for itself by throttling efficient trading in the company’s stock, which drives down the market price of the stock and captures that value in a freezeout transaction. Only by obligating the majority shareholder to pay an amount that includes a marketability discount is the incentive for such inefficient and unfair conduct removed.

Notwithstanding the *Ford* case, lawyers planning acquisitions and investment bankers and other evaluators providing fair value estimates in acquisition settings should not assume that Kentucky courts will apply a marketability or minority discount in appraisal settings. It seems more likely that Kentucky courts will take the first available opportunity to overrule that aspect of *Ford* and thus provide incentives for senior officers and controlling shareholders of Kentucky corporations to manage those businesses efficiently and fairly.

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231 *See supra* notes 7–51 and accompanying text.

232 In an extreme case, an acquirer could purchase fifty-one percent of a company and then cause the company to de-list from an exchange or Nasdaq. This would almost certainly cause a reduction in the price of the company’s stock, since transaction costs in acquiring and selling the company’s stock would become higher after de-listing. If the acquirer then freezes out the minority and is not obligated to pay them for the loss in value—i.e., is able to freeze them out without paying the marketability discount—there is an incentive for a controlling shareholder to engage in non-value maximizing conduct. The outcome is once again both inefficient and unfair to the minority shareholders.

A more subtle, but nonetheless troubling, version of this can occur in a more closely held company with limited trading activity. In such a case, if a majority shareholder is able to freeze out a minority without paying the minority discount, he also has an economic incentive to maintain high trading transaction costs, which again is inefficient and unfair to the minority.

In all cases, therefore, rejecting a minority discount promotes fairness and efficiency.
b. Valuation Methodology

The court in *Ford* utilized a weighted average valuation method in determining the fair value of dissenters' rights. In a weighted average valuation, an evaluator establishes up to four different valuations, each of which is based on a separate factor. The most common factors utilized by courts when arriving at a weighted average value of a company or a portion of a company are: market value, asset value, earnings value, and dividend value. To arrive at a final weighted average value, the evaluator, after selecting the components and putting a value on each, assigns weights to each factor. At the time *Ford* was decided in 1982, Delaware courts mandated the use of a weighted average valuation method in all Delaware acquisition cases. Indeed, the weighted average method was often called the Delaware block approach.

In the year following the *Ford* decision, however, Delaware abandoned mandatory use of the weighted average valuation method in the *Weinberger* case, declaring that the “weighted average method of valuation . . . shall no longer exclusively control such proceedings.” Instead, the court concluded that courts must use “a more liberal approach . . . [that includes]

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234 To use a concrete example, assume that the evaluator determines market value to be $100, asset value to be $110, earnings value to be $120, and dividend value to be $130 and weights the components respectively at 20%, 30%, 30%, and 20%. The present value would be determined as follows:

\[
egin{align*}
\text{Present value} & = 100 \times 0.2 = 20 \\
& + 110 \times 0.3 = 33 \\
& + 120 \times 0.3 = 36 \\
& + 130 \times 0.2 = 26 \\
& = 115
\end{align*}
\]

“The weights assigned to factors vary from case to case, and, indeed, not all of the four factors are accorded weight in all cases. Dividend value, for example, is the particular element of value that is omitted from consideration most often.” Rutheford B Campbell, Jr. *The Impact of Modern Finance Theory in Acquisition Cases*, 53 SYRACUSE L. REV. 1, 16 (2003) [hereinafter Campbell, *The Impact of Modern Finance Theory*].


Even before *Weinberger*, however, Delaware courts sometimes failed to follow all aspects of the Delaware block approach. See, e.g., *David J. Greene & Co. v. Dunhill Int’l*, Inc., 249 A.2d 427, 433 (Del. Ch. 1968) (“[W]e are not obliged to blindly use past earnings without reference to other factors of record.”).

proof of value by any techniques or methods which are generally considered acceptable in the financial community.\textsuperscript{237}

Although \textit{Weinberger} clearly manifested a lack of confidence in the validity of the weighted average method of valuation, jurisdictions, including to some extent Delaware, continue to utilize the weighted average method of valuation in a significant number of cases. Since \textit{Weinberger}, non-Delaware jurisdictions have used the weighted average method in about half of their valuation cases, while Delaware has utilized the method in approximately fifteen percent of its valuation cases.\textsuperscript{238} Non-Delaware jurisdictions actually seem to be increasing slightly their dependence on the weighted average method in acquisition cases.\textsuperscript{239}

\textit{Ford} appears to mandate a weighted average valuation method as the exclusive valuation method to be used in all Kentucky appraisal cases. At one point, for example, the court stated that "in all appraisals or valuations of fair value of stock, pursuant to [Kentucky's appraisal statute] . . . the three elements to be considered in computation of the fair value of shares . . . are market value, investment or earnings value, and net asset value."\textsuperscript{240} At another point, the court stated that "the weight to be given to each element depends on the circumstances of each individual case."\textsuperscript{241}

While on its face this language is confined to appraisal proceedings, one also might expect the same valuation methodology to be used in other settings involving business valuations, since there seems no logical reason to vary valuation methodologies as a function of the legal issue before the court. Thus, for example, one should expect the valuation methodology used by courts in appraisal cases also to be used in a case in which a minority shareholder complains that managers and controlling shareholders violated their fiduciary duties by failing to accord minority shareholders a "fair price" in an affiliated merger.

\textsuperscript{237} \textit{Id.} at 713.

\textsuperscript{238} In an article published in 2003, I found that in seventy-seven cases decided in various jurisdictions after \textit{Weinberger} (1983), courts in thirty percent of those cases used a weighted average method of valuation. See Campbell, \textit{The Impact of Modern Finance Theory}, supra note 234, at 18 tbl.1. Forty-three of the seventy-seven cases were decided in Delaware, where the courts used the weighted average valuation method in fourteen percent of the cases. \textit{See id.} at 22 tbl.4. Thirty-four of the seventy-seven cases were decided in non-Delaware jurisdictions, where the weighted average method of valuation was used in fifty percent of the cases. \textit{See id.} at 22 tbl.5.

\textsuperscript{239} \textit{Id.} at 25 tbl.8 & tbl.9. (in non-Delaware jurisdictions, forty-four percent of cases decided between \textit{Weinberger} and the end of 1990 used the weighted average valuation method; fifty-six percent of all cases decided after 1990 used the weighted average valuation method).

\textsuperscript{240} \textit{Ford v. Courier-Journal Job Printing Co.}, 639 S.W.2d 553, 556 (Ky. Ct. App. 1982).

\textsuperscript{241} \textit{Id.} at 555.
Notwithstanding the strong and potentially expansive language in *Ford*, Kentucky courts should take the first available opportunity to reject a weighted average valuation methodology as an acceptable way to arrive at present value in acquisition cases. The weighted average method of valuation has never made any sense. It is riddled with double counting and indirection or, more appropriately, misdirection.\(^{242}\) With regard to the double counting matter, consider the three factors used in *Ford*—market value, earnings value, and net asset value.\(^{243}\) Market value impounds both the value of the company's earnings and its net assets. Obviously an efficient market will place a higher value on a firm with high earnings than on an identical firm with low earnings. Similarly, a firm with a lot of net assets will enjoy a higher market value than an identical firm with few net assets, since the net assets will provide more of a cushion in the event of a business failure.\(^{244}\) In using the *Ford* approach, therefore, one is either double counting earnings and net assets or somehow weighting earnings and net assets to avoid double counting. The latter is difficult even to conceptualize, let alone apply.

Another problem with the weighted average methodology, apparent in the foregoing discussion, is the matter of how one selects the various weights assigned to the individual components of value. Sensible criteria for weighting have never been established or, indeed, even offered.\(^{245}\) Thus, the weighted average method of valuation has been the focus of sharp theoretical criticism over the years. See, e.g., Joseph Evan Calio, *New Appraisals of Old Problems: Reflections on the Delaware Appraisal Proceeding*, 32 AM. BUS. L. J. 1, 38-41 (1994).

\(^{242}\) The Delaware block approach often used less than all four of the components described above. See Campbell, *The Impact of Modern Finance Theory*, supra note 234, at 16. The component most often omitted is dividend value. See VICTOR BRUDNEY & WILLIAM W. BRATTON, *BRUDNEY AND CHIRELSTEIN’S CORPORATE FINANCE CASES AND MATERIALS* 708-09 (4th ed. 1993) (noting that in only two of eighteen reported cases was dividend value included in a Delaware block evaluation).

\(^{243}\) For example, assume both Firm A and Firm B have the same expected earnings of $100 in each of the next three years. Because of economic uncertainties, each firm has a 20% chance of discontinuing operations at the end of the three years. Firm A, however, in order to operate during the period will maintain net assets that constantly will be worth $100, while Firm B will maintain net assets worth only $10. The efficient market will likely place a higher value on Firm A, since the net assets of Firm A provide a cushion for the owners of Firm A in the event of a business failure at the end of the three-year period.

\(^{244}\) See Campbell, *Fair Value*, supra note 203, at 39; see also Calio, *supra* note 242, at 37 ("[V]irtually no weighting guidelines exist."). Calio goes on to explain that "[t]he weight assigned to each of the [components] . . . is usually reflective of the confidence level or accuracy of each element’s valuation." *Id.* I offered a critical comment on this theory of weighting:

To assign weights according to the court’s confidence in the accuracy of the particular factor is, at best, sophistry. The fact, for example, that a court can most accurately determine the liquidation value of the corporation says nothing about
the statement in *Ford* that "the weight to be given to each element depends on the circumstances of each individual case" is typical in that it provides no hint regarding any sensible, principled basis for assigning weights in future cases.  

Instead of the tired and theoretically flawed weighted average method of valuation, Kentucky courts should adopt a discounted cash flow valuation methodology for use in all acquisitions cases. Under the discounted cash flow method, the evaluator projects the expected return from the investment. To arrive at a present value, the total expected return is discounted in order to reflect the time value of money and the economic risk inherent in the anticipated cash flow.

Fundamentally, the superiority of a discounted cash flow valuation is due to the fact that the methodology proceeds from rational "psychological and behavioral bases for economic value." Rational people invest their money—thereby deferring consumption and alternate uses of their money—because they believe that the investment will make money for them in the future. How much a rational investor is willing to pay for any investment, therefore, depends on how many dollars they expect to receive over a given period of time, how much they value alternate uses of the

\[ \text{Present Value} = \frac{\text{Expected Return}}{(1 + r)^n} \]

whether using such a valuation is consistent with the court’s obligation. Courts are not obliged to select an improper method of valuation simply because it is easy to calculate.”


Since the goal in appraisal and other valuations growing out of acquisition litigation is to arrive at some sort of market value, see, e.g., *Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1134, 1143 (Del. Ch. 1994) (“the highest value reasonably achievable”), *aff’d*, 663 A.2d 1156 (Del. 1995), it would be logical to assign the same weights to various factors as the market would assign. The best evidence of that, of course, is the market value itself, if the market for the company’s stock is efficient and unflawed. In most instances, however, the actual market value is unsuitable for valuation purposes, because of imperfect information (for example, material information about the company may be hidden from the market), mismanagement or undermanagement (for example, a parent company that intends to acquire the publicly held minority interest in its majority owned subsidiary may, in anticipation of the acquisition, drive down the market price of the subsidiary’s publicly held minority interest by undermanaging or mismanaging the subsidiary), or structural matters (for example, an efficient market may lower the value of a company that has an identifiable majority shareholder, since investors may fear an unfairly priced acquisition by the parent).


In an earlier article, I argued that there is a “disconnect between the factors and their assigned weights under the Delaware block approach ... and the psychological and behavioral bases of economic value ...” Campbell, *The Impact of Modern Finance Theory*, supra note 234, at 39–40.
money they intend to invest, and the risk associated with the expected return. Thus, for example, an investor will pay more (i.e., assign a higher present value) for an investment with higher anticipated cash flows but will pay less (assign a lower present value) for an investment that is more risky.

The discounted cash flow method of valuation focuses directly on these critical elements of present value. An evaluator using this method is obliged to quantify both the anticipated cash flows and the discount factor, which is, in turn, a quantification of risk and the time value of money. Financial economists overwhelmingly agree that a discounted cash flow methodology is the correct way to estimate present value. Uniformly, this valuation method is extensively utilized and taught in financial texts. For example, Professors Brealey and Myers' widely adopted text, Principles of Corporate Finance, devotes many pages to an explanation and utilization of the discounted cash flow method. At one particular point in their textbook, the authors unequivocally state that "[v]alue today always equals future cash flow discounted at the opportunity cost of capital." Not surprisingly, more sophisticated courts now rely more heavily on the discounted cash flow method of valuation. Data indicate, for example, that in Delaware, during the first eight years after courts were freed from mandatory use of the weighted average method, courts relied on the discounted cash flow method of valuation in forty-four percent of their cases. In later cases, the Delaware court utilized a discounted cash flow method in fifty-two percent of its cases. Even these Delaware numbers are disappointing, since the discounted cash flow method is inevitably the way courts should determine present value. Nonetheless, the data

250 See id. at 5.
252 Id. at 73. The "opportunity cost of capital" impounds risk and the time value of money. See also Mukesh Bajaj et al., Firm Value and Marketability Discounts, 27 J. CORP. L. 89, 91 (2001) ("[T]he price of any asset is given by the present value of the cash flow to be received from owning the asset.").
253 Campbell, The Impact of Modern Finance Theory, supra note 234, at 26 tbl.6.
254 Id. at tbl.7.
255 It is nearly impossible to imagine a case in which the use of the discounted cash flow is inappropriate. For example, imagine a case in which the assets of a company are worth more liquidated than as a going concern, and so the company is to be liquidated and should, therefore, be valued as a liquidated entity. Even then, one should utilize a discounted cash flow method of valuation. It would be inappropriate to value the company based entirely on the cash that will be recognized from the sale of the company's net assets. This is because it will take some time to liquidate the company, thus the asset value must be discounted for the time value of money, and the amount to be received at the sale is not a sum certain, and thus the amount must be discounted for risk. If one assumes in this example that the
demonstrate that the discounted cash flow method has significant traction with the sophisticated Delaware court.256

By adopting a discounted cash flow methodology for all acquisition cases, Kentucky courts could establish a valuation method that is founded on realistic psychological and behavioral bases, overwhelmingly supported by modern finance theory and significantly supported by enlightened court opinions from sister jurisdictions.

V. CONCLUSION

Considered as a whole, Kentucky statutes and cases offer a surprisingly deep source of corporate fiduciary rules and principles. Properly interpreted, these rules and principles are generally sound.

Kentucky law obligates corporate managers to act in the best interests of shareholders, subject to the right of managers to make limited amounts of wealth transfers to other constituencies. This is a position consistent with the common and statutory law of Kentucky’s sister states. Also in sync with sister states is Kentucky law’s suggestion that fiduciary duties vary depending on whether the corporate manager is engaged in monitoring or making a discrete decision. Regarding the making of discrete decisions by fiduciaries, one should expect—especially in light of Kentucky’s common-law traditions—that Kentucky courts will impose increasingly higher standards on fiduciaries as their depth of conflict increases. Accordingly, Kentucky courts are likely to limit the applicability of Kentucky’s business judgment statutes to unconflicted, discrete decisions and confirm as a matter of common law the applicability of the proportionality test for quasi-conflicted discrete decisions and the intrinsic fairness test for deeply conflicted discrete decisions.

In a number of areas, Kentucky’s common law is sound. Examples of this include Kentucky’s strong version of managers’ obligation to disclose material facts about the corporation and its economically sensible approach

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liquidation will be completed in one year and that there is a 50% chance that the net assets will bring $100 and a 50% chance that the net assets will bring $80, the expected value of the “cash flow,” which is $90, must be discounted because it will not be received for one year and there is some risk that the receipt will be something different than $90. See Campbell, The Impact of Modern Finance Theory, supra note 234, at 9–10.

256 Perhaps somewhat counterintuitively, the discounted cash flow would be substantially easier for courts to manage than other valuations, such as the weighted average method. See Campbell, The Impact of Modern Finance Theory, supra, note 234, at 46–47 (“[J]udgments courts . . . are asked to make . . . involve more of the types of decisions that courts are able to handle and, indeed, the types of decisions that historically they have always made.”).
to the right of fiduciaries to compete with their corporations. Kentucky courts, however, still face challenges. Courts must avoid adopting the confusing analyses that seem to permeate much of Delaware’s common law. Fiduciary duty rules should be approached clearly, directly, and simply as standards of conduct that are based on traditional tort norms and offer remedies to shareholders harmed by managers’ failure to follow the prescribed standards. Kentucky courts, therefore, should view their function in terms of enforcing a standard of conduct and not in terms of applying a standard of review. Similarly, a violation of the business judgment statutes by a Kentucky fiduciary should render the case one for damages. In such circumstances, Kentucky courts should not engage in another analysis under the intrinsic fairness standard before constructing remedies.

Finally, it is in the area of acquisitions that Kentucky seems to be most misdirected. While it is sound to reject the business purpose doctrine and the exclusivity of appraisal rights, Kentucky should also reject minority and marketability discounts and use of the weighted average method for valuations. The development of fiduciary principles has shown the inappropriateness of such discounts, and modern finance theory uniformly accepts the discounted cash flow method as the way to calculate the present value of a business.