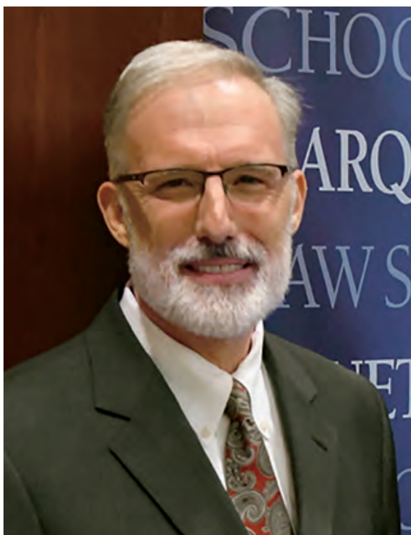
Of LLCs, ESGs, Diversity, and Virtual Annual Meetings

Delaware Vice Chancellor J. Travis Laster talks with Marquette Law Professor Nadelle Grossman about the state of corporate law.



Hon. J. Travis Laster

In March 2020, the Hon. J. Travis Laster visited Marquette University Law School as its annual Hallows Judicial Fellow. Laster is a vice chancellor of the Delaware Court of Chancery, having served on the court since 2009. He is a recognized authority on corporate law, and in early 2021, he sat for a conversation (by Zoom) with Nadelle Grossman, professor of law and associate dean for academic affairs, whose teaching and research focus on corporate law. These are lightly edited excerpts of their conversation.

Professor Nadelle E. Grossman: Let me kick us off with asking you this: In the pandemic, a lot of companies are holding virtual shareholder meetings. I think a lot of shareholder activists are supporting this, thinking it can lead to increased engagement. But I have seen institutional investors also claim that having virtual meetings has been leading to less transparency because shareholder voices can be hidden from the other shareholders. I'm curious what you think the shareholder meeting will look like going forward.

Vice Chancellor J. Travis Laster: I will tell you that I haven't had a lot of direct involvement in this. But when the pandemic hit, the governor of Delaware, with advice from the Council of the Corporation Law Section of the Delaware State Bar Association, put out an emergency order that allowed companies to shift their meetings from in person to virtual simply by providing a notice to shareholders in an SEC filing. This was followed up with legislation. So the transition to virtual meetings really happened without any court involvement, and there weren't any disputes. But for that order, one might imagine that some plaintiff's counsel might have tried to argue that because a company noticed the meeting in person, it had to occur in person. But people were also being fairly realistic about COVID at the time.

I am familiar with some scholarly research on this topic. Megan Shaner, a professor at University of Oklahoma, has written on this subject with Yaron Nili, a professor at the University of Wisconsin–Madison. What they found is that the shifting to virtual meetings did not decrease voting participation levels and that it may have actually increased retail investor participation, particularly at places like Walmart, Berkshire Hathaway, and Google, where you almost

have a rock concert of an annual meeting. But there wasn't a lot of change among institutional investors.

I would think that virtual annual meetings are here to stay and that, to the extent that people have complaints about lack of participation or things like that, those things will be tweaked by changing or updating the annual meeting format rather than going back to in person, because in person in this day and age isn't a good method. It doesn't drive a lot of participation, and it doesn't drive a lot of attendance. You might get a few gadflies who are there to make a point, but the idea of the annual meeting as a deliberative gathering, I think, really is anachronistic. And so I hold out hope for the virtual annual meeting, and I think that it's probably something else that is a change that was coming, but which the pandemic has dramatically accelerated.

Grossman: I'd like to pose a few questions on board diversity. Of course, as you know, there's significant momentum toward diversifying boards. Mandates come from state legislatures like California, as well as the proposed NASDAQ rule, in addition to there being policy statements by large institutional investors in favor of board diversity. Are these movements impacting the development of corporate law in Delaware? Do you think they will or should?

Laster: So the short answer is they haven't come to us yet. My personal opinion is that this is a fundamental good; that this effort to promote diversity is a social good, and it's likely to promote better decision-making, from what I know about decision-making. Under decision-making theory, groups make better decisions when they have different sources of experience to draw on. Having different backgrounds and life paths and views and perspectives in the boardroom should go a long way to enhancing decision-making. So from a policy standpoint, I think it's an unmitigated good.

But the question I think becomes more complicated at the level of implementation for Delaware because of the internal affairs doctrine. And so to the extent that diversity is legislated by, for example, California for all corporations within its borders, even corporations that are formed elsewhere, this creates a tension under the internal affairs doctrine, which is, frankly, a dispute that I personally would rather us not have. So if you think about it purely from an internal affairs standpoint, there's tension between California's imposing this rule on Delaware corporations and how we normally look at questions of board composition and internal governance, where Delaware law—without this mandate—would control.

Now Delaware is a private-ordering jurisdiction. So if a corporation adopted a pro-diversity provision in its charter or bylaws establishing director qualifications, or even if a corporation set up different types of directorships (which have to be in the charter under section 141(d)), that is something that a Delaware court would enforce. But because we're a private-ordering jurisdiction and because we tend to protect that value, the imposition of these requirements by a coequal state could create an unfortunate collision. I don't know anyone who is anti-diversity, so I think it would be very disappointing if this collision happened, and I hope it never does.

There isn't the same problem with stock exchange listing requirements because those listing requirements essentially operate as an overlay on top of the Delaware state law regime, and so there isn't the same internal affairs collision, even though substantively you have the same effect. For example, the New York Stock Exchange requires a stockholder vote for the issuance of shares equal to 20 percent of the issuer's capitalization. Delaware doesn't. Delaware has no problem with the New York Stock Exchange provision or NASDAQ's similar requirement. Yet if another state had the same provision requiring a stockholder vote [and applied it to Delaware corporations], that would be a problem. We examined this issue in the *Vantagepoint* case. In that case, our supreme court found California's law conflicted with the internal affairs doctrine and rejected its provision.

So that's an example of how this could come up. I hope that this does not come up because I think it's one of those areas where it would risk a negative development and a potential for an understandable backlash if a Delaware court declared the internal affairs doctrine applicable and hence held a pro-diversity statute was inapplicable to Delaware corporations. I just don't like the optics of that, though from a strict corporate law standpoint, I think that is probably the correct result as an internal affairs matter.

Grossman: I have one more question relating to diversity. I'm curious about your view of whether a nominating committee might face potential liability for repeatedly failing to consider women, people of color, or other individuals with diverse backgrounds for board membership when it's considering whom to nominate to the board.

Professor Nadelle E. Grossman

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—Delaware Vice Chancellor J. Travis Laster

Laster: The reality is that the business judgment rule allows people to be stupid, and the business judgment rule allows people to be shortsighted. And so if you had essentially a reactionary, patriarchal sort of white-male focused board that wanted to return to some prior era, I don't think that they would face liability as a fiduciary matter.

Now the calculus could change if there were, for example, a charter or bylaw provision that required diversity or imposed a board qualification, because there's some tension in Delaware law about the extent to which a board can rely on its fiduciary duties to avoid compliance with a bylaw, as, generally speaking, bylaws are binding on the board. So if stockholders implemented a bylaw that required consideration of diversity and then the board resolutely refused to do it, that is a different question.

I tend to suspect that Delaware would default to the power of the stockholders to vote out these recalcitrant, backward-looking directors as opposed to using a judicial remedy through liability. But I think that, absent some type of charter or bylaw, the business judgment rule would allow them to be reactionary and antiquated.

Grossman: I have a few questions relating to fiduciary duties generally. At the Hallows Lecture that you gave at Marquette Law School last year, you pointed to *Marchand v. Barnhill*, a 2019 decision involving a listeria outbreak at Blue Bell Creameries, as an example of the Delaware Supreme Court's recent invigoration of the duty of oversight, potentially holding directors liable for the failures to oversee "mission critical" aspects of the business. In your view, what's the significance of this case in Delaware fiduciary duty law?

Laster: So *Marchand* is potentially significant because it was the first time in a major decision that the Delaware Supreme Court upheld a *Caremark* claim. I think it's as much an attitudinal shift as anything else. Before *Marchand*, the standard statement was that *Caremark* claims were the most difficult theory to bring under corporate law. And there was essentially an expectation that "difficult to bring" almost equated with "impossible to survive a motion to dismiss." And what *Marchand* did was show that a complaint could survive a motion to dismiss.

Now there is still a high hurdle to survive a motion to dismiss: You still need facts that would support an inference of bad faith. In *Marchand*, those facts were specific allegations that there was no board-level reporting system that would keep the board apprised of food-safety risks. At an ice cream company, this was a mission critical issue. It changes people's approach to oversight cases when the Delaware Supreme Court does not dismiss a *Caremark* claim.

The other aspect of *Marchand* that I think is important is that, historically, the Delaware courts regarded compliance with federal regulatory regimes as sufficient for Delaware law purposes. To elaborate on that a little bit: If you're a company that makes food, then to comply with FDA regulations, you are going to have to have certain protections and reporting obligations and procedures that you follow, certifications, etc. And what historically would happen in *Caremark* cases—and this is also true for banks that have to comply with bank secrecy and anti-money-laundering laws, car companies that have to comply with transportation regulations, and mine companies that have to comply with mine-safety law—is that companies would point to the federal system and argue that compliance with the system was sufficient for purposes of board oversight.

And what the Delaware Supreme Court said in *Marchand* was that that is not necessarily true. Now it didn't rule out the possibility that, in many cases, that *will* be true. But in *Marchand*, the fact that the company had all of the operational checks in place to comply with FDA regulations was not enough for the Delaware Supreme Court to find an adequate reporting system in place. The Delaware Supreme Court wanted a board-level system that built on those federal requirements and went a step beyond. I think that that's likely to be significant because, again, it changes the historical approach of satisfying *Caremark* by pointing to regulatory compliance structures. Going forward, that may not be true. I still think it's going to take egregious facts to support any type of *Caremark* claim, but we've

learned that they're not impossible to plead, which is a significant attitudinal shift.

Grossman: As you know, in 2019, the Business Roundtable issued an updated statement on the purpose of the corporation, which was signed onto by 181 CEOs, including the CEOs of many Delaware corporations. According to the statement, "While each of our individual companies serves its own corporate purpose, we share a fundamental commitment to all of our stakeholders. We commit to: . . . [i]nvesting in our employees. This starts with compensating them fairly and providing important benefits . . . [,] supporting the communities in which we work . . . [, and] [g]enerating long-term value for shareholders, who provide the capital that allows companies to invest, grow and innovate." Does this statement of corporate purpose comport with Delaware corporate law? Relatedly, do you think this statement might lead to a shift in normative expectations for officers and directors of Delaware corporations?

Laster: It's certainly a statement that got a lot of press, and it's certainly a statement that was pitched as suggesting some major change toward stakeholder theory and away from stockholder theory, in the sense of the ultimate beneficiaries of fiduciary duties. When I read the statement at the time and when I hear you read it again now, the language strikes me as quite soft. And I think what the Business Roundtable is reacting to is really a caricature of fiduciary duties as stockholder-focused. That caricature is not consistent with what I think the Delaware law regime is. I think that that caricature has been very effectively used by, for example, hedge fund managers and other institutional investors as a rhetorical trope for why directors should do things that they think would boost the stock price.

It's important to stress that Delaware does not equate stockholder welfare with stock price. When Delaware speaks to fiduciary duties, we say fiduciary duties are owed to the corporation for the ultimate benefit of its stockholders. Duties are ultimately owed to stockholders because they are the people who provide capital to the corporation with no right to ever get it back. So they are contributing their capital permanently to a firm which, under Delaware law, has presumptively permanent life. Importantly, *stockholders* refer to the stockholders as a whole.

Now, we know in a public corporation, shareholders can sell their shares. But in that situation, the firm is not giving capital back. The capital itself is locked in. So when Delaware speaks of obligations that ultimately run to stockholders, it's to the longest of long-term holders. And when you're talking about the longest of long-term holders, that group is synonymous with the interests of the corporation as a whole, which necessarily take into account things like benefits to employees, good relations with customers, good relations with suppliers, and even larger externalities. If anyone has reason to be concerned about how our society functions or whether climate change is a real problem, it's the people who have to think about being here permanently. So in my view, the stockholder metric that Delaware applies is a long-term metric that, I think, should do the best job of taking into account these various considerations.

Now what I do think is happening is a valuable and understandable pushback against this rhetorical approach to stockholder value, which seems to put short-term stockholder gains and the profits of fund managers and their investors above everything else. But I think it's fundamentally based on a misconception of Delaware law. And so what we have right now, to some degree, is one misconception talking to another misconception—in other words, a misconception by the people who believe that the law is short-term stock price focused, and then people responding to that saying, "No, we need to move to some type of stakeholder theory."

I do think ultimately this will play out at the societal level rather than necessarily at the doctrinal level. I also think that there is dramatic, understandable, and justified concern about income inequality in our society and whether we are on the right track in terms of income inequality. I think few people begrudge their fellow people who, you know, do well and generate wealth, etc. But at some point, it hurts everybody to have a society where the middle class disappears, and I think that concern is part of what we're seeing in the Business Roundtable letter.

It's understandable, and I'm sympathetic. I tend to think that the real solutions are harder. I think the real solutions aren't going to be found in a Business Roundtable press release. I think the real solutions are going to be found in things like better education, better infrastructure, health care—things that require broad-based societal planning. But those are harder solutions than just saying we want to take other stakeholders more seriously.

Grossman: A lot of companies issue ESG [environmental, social, and governance] statements and have a lot of disclosure about that which is not required. Is there anything within Delaware law (ignoring fraud for misstatements and omissions in those statements) that might promote a focus on ESG, apart from the long-term nature of fiduciary duties?

Laster: I think that the benefit corporation is a nice solution because it's a standalone statute with a ready-made form, and it comes basically branded and everybody understands what you're doing. So you don't have to do private ordering to achieve ESG, and there's value in that.

ESG goals can also be achieved under the corporate code. The core provision in the Delaware code, section 141(a), empowers it. It says that the corporation shall be managed by or under the direction of a board of directors, except to the extent the certificate of incorporation provides otherwise, and (to the extent it does) shall be managed in accordance with the certificate of incorporation. So I have always read that as saying that if you built into your charter these types of provisions, then the board was obligated to manage in accordance with those provisions. I don't think there's a specific case that says this; I flagged it in the *Trados*[1] case as something that was a possible way to solve what was perceived to be tension between preferred stockholders and common stockholders, but I think you could use that private-ordering power to drive some type of ESG motivation or even a benefit corporation motivation.

Absent that, I think you're right: The ESG issues really come into business judgment and the long-term value of the corporation. And we expect that directors would be considering these things when you're talking about a potentially perpetual entity. It's like the old theory of planning seven generations out. When you're dealing with a perpetual entity, you should be thinking absolutely about the longest of the long term, but I don't think you could point to anything prescriptively that would require it.

Grossman: I have one final question for you—it's definitely a gear shift. As you know, the number of newly formed LLCs in Delaware now surpasses the number of newly formed corporations, on the order of over three to one. But most notable business law decisions continue to relate to Delaware corporations. Of course, there are some notable LLC cases, but I'm wondering why most still involve corporations.

Laster: I have a special interest in LLCs. Two years ago, I taught a three-credit course on LLCs at Rutgers Law School. There isn't a very well-established casebook on LLCs—maybe that's part of the problem. The other problem with LLCs is that they are the moldable clay of entity law. You can make them into whatever you want. There are very few mandatory provisions, and because of the contractual freedom, you can create an LLC that looks like a corporation. You can create an LLC that looks like a limited partnership. You can create an LLC that looks like a flat partnership—and, indeed, by default, the LLC structure is a flat partnership structure.

So you have this shape-shifting entity where individual cases tend to deal with individual LLC agreements. I decide a lot of LLC cases. Our court does a lot of LLC cases. I think there may just be some lag here. I also think that, at least in terms of law schools, the corporation remains the default entity and so in the Business Organizations course, you spend a lot of time with corporations. The course that I was teaching on LLCs, it was an advanced class, and it assumed you'd already dealt with the main cases of corporations.

I think you're right that there haven't been one or two or three big iconic LLC cases that we all know, the same way we all know *Unocal* and *Revlon* and *Weinberger* and *MFW* and cases like that.

I don't think it's that they resolve privately a lot, and it's not that the cases aren't happening. I do think that it may be that you are dealing with this shape-shifting entity. I can tell you that, in Delaware at least, a decision that I wrote in a case called *Feely* and a decision that the Delaware Supreme Court issued in *Auriga* are pretty important because they address the extent to which there are default fiduciary duties in an LLC.[2] But what we don't have a lot of in the LLC world is big public takeovers—big sorts of high-profile events—and maybe that's part of it, too. But it's a good observation, that we don't yet have the iconic LLC cases.

Grossman: Thank you so much, Vice Chancellor Laster, for taking time for this interview, and for your candid answers to my questions. I am confident that our readers will find them insightful. ■

1 *In re Trados Inc. Shareholder Litigation*, 73 A.3d 17 (Del. Ch. 2013). – Ed.

2 The question reserved in the Delaware Supreme Court's opinion in *Gatz Props., LLC v. Auriga Capital Corp.*, 59 A.3d 1206 (Del. 2012), whether default fiduciary duties existed in LLC law, was resolved by legislation the next year. See Del. Code § 18-1104. – Ed.