Inside the Boardroom: A Proposal to Delaware's Good Faith Jurisprudence to Improve Board Passivity

Abstract. This Note has two goals. First, it seeks to explain why boards of directors at large corporations tend to stay passive in performing their monitoring role. Second, this Note argues that Delaware corporate law fails to take into consideration the factors that lead to board passivity because Delaware courts currently adopt a transaction-focused approach by only examining facts surrounding the transaction that is the subject of litigation. This Note proposes that the Delaware court looks beyond the transaction in dispute and adopts an expansive good faith evaluation for overall board operations.

I. Introduction

In a typical law school's introductory course on business organizations, we learn the legal relationships among three important actors of a firm: the shareholders, the board of directors, and the executives. The board as a whole constitutes the top-level manager of the firm,[1] while the executives are the day-to-day manager of the firm. The law assumes that shareholders are the owners of a firm, that shareholders elect the board members, and that the board selects the firm's executives. Accordingly, a firm's executives are simply agents of the firm's principals, i.e., the shareholders. The board of directors stands in between the agents and the principals to closely monitor the firm's executives in order to maximize shareholders' interest.

In contrast to the corporate structure idealized in the legal world, a typical real-world publicly traded corporation often has a much different structure. A firm's executives not only are the day-to-day managers of the firm, they also behave as if they own the firm. Most often, the executives choose the candidates for the board members, and the shareholders simply ratify the executives' choice.[2] The board does not know most of the true "owners" of the firm, i.e., the shareholders. Rather, the board remains passive most of the time, except perhaps during crisis.[3] The board also defers to the executives' decisions, except perhaps when the firm is performing so poorly that the board has to intervene.[4]

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[1] *See* Automatic Self-Cleansing Filter Syndicate Co. v. Cunninghame, 2 Ch. 34 (Eng. C.A. 1906) (holding that the directors are not agents but are managing partners of the corporation appointed by the shareholders); Continental Securities Co. v. Belmont, 206 N.Y. 7, 16 (N.Y. 1912) ("the directors are not ordinary agents . . . they are trustees with the power of controlling the property . . . without hindrance").
[2] Benjamin E. Hermalin & Michael S. Weisbach, *Endogenously Chosen Boards of Directors and Their Monitoring of the CEO*, 88 AMERICAN ECON. REV. 96, 96 (1998).
[3] *See* Sanjai Bhagat et al., *Director Ownership, Corporate Performance, and Management Turnover*, 54 BUS. LAW. 885, 887-88 (1999).
[4] *See* Michael S. Weisbach, *Outside Directors and CEO Turnover*, 20 J. FIN. ECON. 432, 454 (1987).

Obviously, there is a gap between the law's assumptions and the real-life situation for the board's role in corporate governance. The board developed its current form in modern corporations as a market response to the growing presence of these corporations in the economy. Corporate law came into existence as a legal response to corporate problems that the market does not properly cure by its own force. The legal response, however, frames its solution based on its own assumptions for how the market should behave, even though these assumptions may not be how the market performs in reality.

In the market, this corporate structure consisting of these three actors developed in the early twentieth century when corporate entities grew so large in scale that they needed an enormous amount of capital, for which required not just a few, but a large number of individuals to contribute.[5] As both the size of the corporations and the number of their shareholders grew, no individual shareholder or shareholding group dominated or controlled the corporate entity. Consequently, the professional management class developed to fill the role as daily managers.[6] The result is the separation of ownership and control, where because the owner consists of too many diffuse individuals or groups, collective action problems have made the owner a poor monitor of the agent. The board of directors developed to fill in this monitoring gap. But because the board is chosen by the professional managers, not by the shareholders, the board's interest has always been more aligned with the agent rather than with the principal. Ever since the early twentieth

[5] *See* Sanjai Bhagat et al., *Director Ownership, Corporate Performance, and Management Turnover*, 54 BUS. LAW. 885, 886 (1999).
[6] *Id.*

century when this structure was developed, the law has sought legal mechanisms to align the interest of the board with that of the shareholders.[7]

The legal mechanisms that seek to reform corporate governance follow a spectrum of different assumptions and attitudes towards the role of law in this arena. On one end of the spectrum is the view that capital market provides the necessary incentive for adequate corporate governance. Scholars under this view believe that "'disciplines of the capital markets,' through the threats or actualities of takeovers, would cause managers to take corrective action to improve performance."[8] The other end of the spectrum resonates with the "race to the bottom" view towards Delaware's dominance in the corporate charter market. Because scholars under this view believe that states' competition for corporate charters and the associated franchise fees benefit managers not shareholders, these scholars argue for more federal regulations in place of the current state law for corporate governance.[9] The recently enacted Sarbanes-Oxley Act of 2002 ("SOX"),[10] under which Congress demanded a series of mandatory corporate governance measures, can be seen as a result of this view's advocates.

Neither end of the spectrum, however, provides a satisfactory answer to corporate governance. On one hand, "[o]nly an extraordinary optimist could believe . . . that the . . . takeover activity is an efficient way to deal with the organizational deficiencies of

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[7] *Id.* at 886; *see* ADOLF BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932).

[8] Martin Lipton & Jay W. Lorsch, *A Modest Proposal for Improved Corporate Governance*, 48 BUS. LAW. 59, 59 (1992-1993) (citing Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161, 1169 (1981); Ronald J. Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819 (1981)).

[9] *See generally* William Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 YALE L.J. 663 (1974).

[10] Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 2002 U.S.C.C.A.N. (116 Stat.) 745 (to be codified in scattered sections of 15 and 18 U.S.C.).

American industries."[11] After a century of development of the current corporate form, shareholders are still highly dissatisfied with the inadequate monitoring boards of directors have provided. The recent wave of corporate scandals has once again exposed board passivity in its monitoring role. On the other hand, excessive federal regulation, such as SOX, is unlikely to improve corporate governance but likely to cause significant inefficiency that will eventually be borne by shareholders.[12] Therefore, state law, not the capital market alone or federal law, should continue to shape corporate governance reform. This paper argues that to recapture the duty of regulating corporate governance from the federal government, states, especially Delaware, should reevaluate its idealized legal assumptions for the relationship between the shareholders, the board, and the executives. In order to be able to recognize the true dynamics among these three actors, courts need to expand their review of board operations. In particular, I propose that Delaware courts adopt an expansive good faith evaluation for overall board operations instead of focusing solely on the transaction that's the subject of litigation. In a transaction focused evaluation, courts may not have sufficient facts to understand the true relationship between the directors and the executives. If courts can look beyond one board transaction, the courts are much more likely to understand how the directors perform (or not) their monitoring role.

The next section attempts to explain why the board of directors has a tendency to stay passive. The section evaluates in particular one long-standing corporate governance

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[11] MICHAEL L. DERTOUZOS ET AL., MADE IN AMERICA: REGAINING THE PRODUCTIVE EDGE 39 (1989); *see also* John C. Coffee, Jr., *Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer's Role in Corporate Governance*, 84 COLUM. L. REV. 1145, 1192-95 (1984) (capital market is only an effective monitor in cases of massive managerial failure).

[12] *See generally* Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521, 1529-43 (reasons that a considerable body of corporate finance and accounting research does not support that the substantive corporate governance mandates of the Sarbanes-Oxley Act will improve corporate governance or performance).

measure that seeks to improve board passivity, the use of independent board of directors. Numerous studies have concluded, based on a variety of evidence, that independent directors do not improve corporate performance. This section then attempts to explain why these independent directors have been largely inefficacious in their monitoring role. I provide in this section three recent examples of boards' monitoring failures, in which all involved boards with a majority of independent directors. The next section offers my proposal to the state law's approach to corporate governance. So far, Delaware evaluates a board performance of its fiduciary duties only for the particular transaction in dispute. The business judgment rule largely protects directors' decision from judicial second-guessing. In some recent cases, Delaware courts have emphasized directors' good faith, the absence of which removes the business judgment protection. I propose that Delaware courts expand the good faith evaluation to the overall board operations instead of focusing solely on the transaction in dispute. The final section is the conclusion.

II. Why Does the Board Have a Tendency to Stay Passive and Why Independent Directors Do Not Improve Board Passivity?

In order for a board of directors to vigilantly represent shareholders' interest and to closely monitor a firm's executives, one "intuitive"[13] solution is to fill the board with directors who are independent of the firm's executives. For a long time, many scholars have advocated for such independent directors, also referred to as outside directors.[14] An independent director is usually defined as one who has no financial interest in the firm

[13] Sanjai Bhagat and Bernard Black refer to this solution as following the "conventional wisdom," since the solution appears to be the natural choice when no one is sure what an optimal board's structure should be like. Sanjai Bhagat & Bernard Black, *The Uncertain Relationship Between Board Composition and Firm Performance*, 54 BUS. LAW. 921, 954 (1999).

[14] *See, e.g.*, AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE AND STRUCTURE: RESTATEMENT AND RECOMMENDATIONS (Tentative Draft No. 1); MELVIN A. EISENBERG, THE STRUCTURE OF THE CORPORATION (1976).

other than the director's retainer fee.[15] The assumption is that independent directors, in contrast to inside directors, are less likely to defer to the firm's executives. Although the business community initially opposed to a mandate of the American Law Institute requiring independent directors, having a board consisting of a majority of independent directors has become the present norm.[16] But numerous studies find that independent directors do not improve firm performance and that these directors have a positive influence on firms at best during a crisis.

A. Academic Findings on Independent Directors' Performance

Scholars have characterized a board's functions into two categories: monitoring of a firm's day-to-day performance and intervention during crisis. Professor Romano terms these two categories as the strong form and the weak form of the monitoring board hypothesis.[17] Under the strong form, a board with a majority of independent directors would have a continuous effect on firm performance. Thus, the strong form of the hypothesis predicts a positive correlation between the percentage of independent directors and firm performance. Under the weak form, independent directors are better than insiders to react to gross failures of a firm and to adjust the firm's strategies to correct the failure. Accordingly, the weak form of the hypothesis predicts a positive correlation between the percentage of independent directors and a firm's performance only during crisis.[18]

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[15] *See, e.g.*, Sarbanes-Oxley Act, 2002 U.S.C.C.A.N. (116 Stat.) § 301 (to qualify as independent, the director may not "accept any consulting, advisory or other compensatory fee from the issuer" nor be an "affiliated person of the issuer of any subsidiary").

[16] Roberta Romano, *Corporate Law and Corporate Governance*, 5 INDUS. & CORP. CHANGE 277, 282-83 (1996).

[17] *See id.* at 285.

[18] *See id.*

Numerous empirical studies based on a variety of analytical approaches have sought to measure independent directors' impact on a firm's performance. However, these studies have overwhelmingly concluded that the strong form of the monitoring board hypothesis does not stand.[19] Professors Romano, Bhagat, and Black, in two separate literary reviews, examined dozens of studies, of which have adopted different performance measures and various types of data. They found that "[n]o matter what variable is used to measure performance, virtually all studies find that there is no significant relation between performance and board composition."[20] Significantly, one study, which adopts a definition of independent directors that yields a higher proportion than other studies, finds a significant negative relation between firm performance and board composition.[21]

Studies of specific events of a firm have found some support for the weak form of the monitoring board hypothesis.[22] For example, Professor Weisbach's empirical study, based on data for all 495 NYSE listed companies between 1977 and 1980, finds that "firms with outsider-dominated boards are significantly more likely than firms with insider-dominated boards to remove the CEO on the basis of performance."[23] Professor Weisbach provides a plausible story to explain this result: "[F]ollowing poor performance, firms first respond by adding outsiders to the board. If poor performance

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[19] *See* Romano, *supra* note 16 at 284-90; *see generally* Sanjai Bhagat & Bernard Black, *The Uncertain Relationship Between Board Composition and Firm Performance*, 54 BUS. LAW. 921 (1999) (reviews numerous empirical studies and concludes that these studies find "no convincing evidence that firms with majority-independent boards perform better than firms without such boards").
[20] Romano, *supra* note 16 at 287.
[21] Anup Agrawal & Charles R. Knoeber, *Firm Performance and Mechanisms to Control Agency Problems Between Managers and Shareholders*, 31 J. FIN. & QUANT. ANALYSIS 377 (1996). The study examines the relationship between performance and seven types of control mechanisms a firm generally adopts. Except for board composition, the firms under research have used optimal use of each of the six control mechanisms. For board composition, the study finds that more outside directors have a negative effect on performance, indicating that firms have chosen too many outside directors.
[22] *See* Romano, *supra* note 16; Bhagat & Black, *supra* note 19 at 923-40.
[23] Michael S. Weisbach, *Outside Directors and CEO Turnover*, 20 J. FIN. ECON. 431, 432 (1987).

continues, these outsiders remove the CEO."[24] One separate study further finds that firm performance modestly improves after its CEO is replaced.[25] These two studies combined support the finding that a board dominated by independent directors improves a firm's performance following the firm's poor performance. Studies on other events are less clear-cut than the decision to fire a CEO following poor performance. For example, although some studies find evidence that target firms with majority-independent boards extract higher prices from bidders than insider-dominated boards, the studies do not tell us whether majority-independent boards produce better outcomes for shareholders of potential targets.[26] Further, according to Professors Bhagat and Black, the evidence does not strongly indicate whether independent boards behave significantly more (or less) shareholder-friendly than other boards in terms of adopting takeover defenses.[27] On the other hand, Professor Romano cites some studies that find a positive stock price movement after a firm adopts a poison pill if outsiders dominate the firm but a negative price movement if insiders dominate the firm.[28] Taken as a whole, these empirical studies show that independent boards provide better monitoring for certain types of events such as firing of the CEO following poor performance but less certain results for other events.

Besides measuring directly the correlation between a firm's performance and its board composition, other studies seek to account for the effect of board composition from other angels. After all, the business world is far more complex than the simple

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[24] *Id.* at 454.
[25] *See* David J. Denis & Diane K. Denis, *Performance Changes Following Top Management Dismissals*, 50 J. Fin. 1029, 1055 (1995).
[26] Bhagat & Black, *supra* note 19 at 928.
[27] *Id.* at 930.
[28] Romano, *supra* note 16, at 292-93.

dichotomy of the weak and strong forms of the hypothesis.[29] For example, Gillan et al.'s study finds that different types of firms choose distinctly different approaches to governance choices, implying that different firms require different board structures.[30] Furthermore, April Klein finds that different board committees require different board composition. Significantly, she finds that insider presence on finance and investment committees improves firm performance.[31] These two studies suggest that inside directors provide valuable contribution to a firm's performance. This is because different industries and firms may have varying degrees of agency costs. Accordingly, they require different levels of monitoring from the board. Moreover, different industries may require different sets of knowledge and information from the directors. Thus, a firm may need more insider directors, who tend to have a deeper understanding about the firm than outsider directors, if the firm requires sophisticated guidance regarding unique industry practices.

Finally, the dichotomy between insiders and outsiders may become blurred over time. Professors Hermalin and Weisbach developed a model to show that board independence declines over the course of a CEO's tenure, even though the same independent board composition stays throughout this period.[32] Professors Hermalin and Weisbach quote a leading venture capitalist for this phenomenon: "At the end of the day, most independent directors get neutralized in one fashion or another."[33]

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[29] Romano, *supra* note 16, at 285.
[30] *See* Stuart L. Gillan et al., *Tradeoffs in Corporate Governance: Evidence from Board Structures and Charter Provisions* (June, 2006) (unpublished working paper).
[31] April Klein, Firm Performance and Board Committee Structure, 41 J.L. & ECON. 275, 287-301(1998).
[32] *See* Benjamin E. Hermalin & Michael S. Weisbach, *Endogenously Chosen Boards of Directors and Their Monitoring of the CEO*, 88 AMERICAN ECON. REV. 96, 111-12 (1998).
[33] *Id.* at 111.

B. Explaining These Academic Findings

The consistent findings that independent boards do not improve performance except perhaps during crisis may seem to be counter-intuitive. After all, independent directors are supposed to be better guards for shareholders' interest against executives' abuses because independent directors are, by definition, not subject to the executives' control. However, the consistency of the empirical studies suggests that factors other than independence affect a board's proper monitoring role. This subsection seeks to explain why boards often fail to provide the necessary monitoring desired by shareholders. The subsection first examines characteristics associated with boards in general that tend to adversely affect their monitoring abilities or incentives. The subsection then examines these characteristics for boards dominated by independent directors, and explains why these boards do not perform a better monitoring job except during crisis.

i. Boards in General

At the outset, directors have their own conflict of interest in performing their monitoring role. Unless a firm has a dominant shareholder who selects its share of directors, most directors are chosen not by shareholders but by the firm's executives. As a legal matter, a director should represent the shareholders' interest. In reality, because the executives largely determine who serve as candidates for the directors, the directors have a natural tendency to be more loyal to their appointing party than to their legal constituency.[34] A director gains both monetary compensation in the form of retainer fees and reputational enhancement by sitting at a company's board.[35] If the business world

[34] *See* Bhagat et al., *supra* note 3 at 3 (check page).
[35] *Id.* at 3 (check page).

knows that a person is likely to serve as a strong shareholders' advocate and to be tough to the executives, the executives are simply less likely to choose this person as a director candidate.

More importantly, a firm's directors face the same collective action problem as faced by a large firm's dispersed shareholders. In law and often in academic studies, we assume that the board is a monolithic entity. But instead, the board is composed of individuals.[36] When there are individuals in a group, collective action problems exist if each member's pro rata share of the benefit from a particular action is less than the cost for the individual member. This mismatch of benefit and cost is often the case for the board of directors except perhaps during a crisis. The relatively remote benefit to most directors for monitoring is slight comparing with the high cost to each of the individual directors. Three factors contribute to this mismatch: the board's non-hierarchical structure, the incentive structure for the directors, and the board's large size.

Directors are mostly of equal status on the board, unlike the hierarchical structure for a firm's executives where the head of each group is accountable for both the full benefit and the full cost of that group's performance. Directors often serve on a board either for their historical contribution to the firm or for their expertise or reputation in a particular field. Although many directors are also shareholders of the firm, they do not necessarily have to own shares. As a result, the benefit to an individual director for monitoring is the reputational gain, often slight and remote, when monitoring improves the firm's performance. The cost of monitoring to an individual director, by contrast, could be significant. As discussed above, directors often owe their job to the executives'

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[36] Hermalin & Michael S. Weisbach, *Boards of Directors as an Endogenously Determined Institution: A Survey of the Economic Literature* (unpublished working paper, p.32).

discretion. If an individual director is perceived of being aggressive to the executives, the director may lose the job and the associated retainer fee and reputational enhancement. On the other hand, if the firm performs poorly, each individual director only bears a small portion of the blame because all the directors on the board share the responsibility equally. Perhaps only when the firm experiences a crisis, the proportionate reputational cost to an individual director justifies him or her to start monitoring actively.

The incentive structure for the board of directors further aggravates the collective action problem. Board directors in general have limited time dedicated to monitor. They only work part time, and they do not get paid based on the number of hours they work. Each director is often paid a fixed annual retainer fee for the director's role. Firms also compensate directors for attending meetings or participating in special committees. However, the board usually assigns the number of meetings and committees ahead of time. Accordingly, at the beginning of a fiscal year, each director knows relatively certain his or her compensation, irrespective of how much additional time the director needs to spend. Suppose a member of the board desires to monitor the executives more closely than others. Because the incentive structure does not award the director based on his or her performance or extra effort spent, over time, this director's motivation will likely dwindle.

The large size of most firms' boards is another major contributor to the collective action problem. Many scholars have suggested that boards are too large and recommended that firms reduce the board size.[37] Empirical studies consistently find that

[37] *See, e.g.*, Bhagat & Black, *supra* note 13, at 941-42; Lipton & Lorsch, *supra* note 8, at 64-69.

board size is negatively correlated with firm performance.[38] The larger the board, the less likely an individual director needs to take the blame for the firm's poor performance. Further, the more people a group has, the lower the group's coordination and processing skills become.[39] Therefore, the larger the board, the more severe of the collective action problem is within the board, and the less the board monitors the executives.

Besides the conflict of interest and collective action problems faced by a board, executives' strong incentive to entrench the board further explains board passivity. Executives, for honorable or non-charitable reasons, wish to receive the trust of the board so that the board will challenge the executives' decisions as little as possible. When a firm's performance is good on paper, the board has little incentive or reason to challenge the executives. As a result, the board, shaped by the executives, gradually develops into a harmonious atmosphere where the board significantly defers to the executives and accepts whatever the executives inform them. Thus, even if the executives lie or commit fraud in order to present a rosy picture for the firm, the board is unlikely to step in because the board can hardly detect the fraud. Only when a firm's performance is poor on paper, the board has any reason to intervene. Professors Hermalin and Weisbach phrase the situation: "The more entrenched the CEO is, the less intensely he is monitored."[40]

When we combine all three factors faced by a board: conflict of interest, collective action problem, and executives' entrenchment tendency, we can understand why boards do not monitor as much as shareholders desire. Perhaps the strongest

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[38] *See*, April Klein, *Economic Determinants of Audit Committee Independence*, 77 ACCT. REV. 435, 438 (2002).
[39] *Id.*
[40] Hermalin & Weisbach, *supra* note 2, at 108.

incentive for a board to monitor is the potential shareholders' lawsuit against the board for breach of its fiduciary duty. Yet the current business judgment rule under state law and the availability of director's and officer's liability insurance largely insulate each director from personal liability and thus reduce this incentive.

ii. Boards with a Majority of Independent Directors

Independent directors still face the same conflict of interest and collective action problems. Proponents of independent boards had probably thought that independent directors would face less conflict of interest issues than insider directors: Independent directors do not work with the executives on a daily basis and do not report to the CEO. But in reality, an outsider becomes a director often because the CEO has chosen the outsider on the nomination slate. Thus, most independent directors still owe to the CEO for their jobs. This personal loyalty to the CEO reduces an independent director's incentive to zealously represent shareholders, who are, after all, most likely strangers to the director.

In some sense, the collective action problem is even worse for independent directors than insider directors because the benefit of monitoring to an independent director is lower than insider directors but the cost of monitoring is higher. Unless an independent director is also a shareholder, the independent director, by definition, receives no financial interest in the firm other than the director's retainer fee. In contrast, an insider director has a much stronger financial interest in the firm's performance. An insider may receive bonuses tied to the firm's performance or promotions because of the insider's extraordinary service as an executive. Neither bonus nor promotion is available, however, to an independent director. Moreover, independent directors must spend extra effort than insider directors to get to know the firm, but the compensation structure does not award the independent directors' extra effort. If a firm's business requires its directors to understand peculiar insider information specific to the firm, the firm may require more insiders than independent directors. This explains Gillan et al.'s finding that different firms require different insider/outsider compositions.

Perhaps only with regard to the executives' entrenchment independent directors may perform better than insider directors. Independent directors are usually less familiar with the firm's executives than insiders. Accordingly, they are better than insiders to resist the CEO's entrenchment tendency. But it is only a matter of time before independent directors are able to resist this tendency. Thus, unless the independent directors are recently added to the board, the long-tenured independent directors are probably just as passive as the inside directors. This explains why firms tend to increase independent directors during times of poor performance.[41] New faces in the boardroom are less loyal to the firm's executives, more likely to break the harmonious atmosphere, and more easily to challenge the executives. Thus, they are more likely to remove the CEO for the poor performance.

C. Three Recent Examples of Boards' Monitoring Failures

This section describes three recent and prominent examples of boards' monitoring failures, and in all three examples, the boards had a majority of independent directors. The Disney board's poor decision to hire Michael Ovitz received significant media attention and costly shareholders' lawsuits. The Worldcom's board was so passive and

[41] Actors other than the executives must be responsible for making this change during a crisis. We don't expect an executive to add a slate of directors who will later remove this executive. But who are the responsible actors is less clear. Perhaps during a crisis, strong market forces lead some dominant shareholders to set up.

was overwhelmed by the dominant CEO, which caused the board to stay ignorant during the whole time when the CEO conducted massive frauds. The Enron board, superficially, possessed all the "model" characteristics recommended by the business world. Yet it still failed to challenge any of the questionable accounting schemes that the executives had proposed. The failure of the Worldcom and Enron boards' monitoring led a panic Congress to enact SOX, which required all publicly traded companies to have audit committees composed of independent directors. But independent directors already dominated both the Worldcom and the Enron boards when the wrongdoings occurred, leaving us to wonder what positive effect SOX will achieve.

i. Walt Disney Company

The Walt Disney Company's controversy involved the hiring and firing of Michael Ovitz as Disney's president. In August 1995, Michael Ovitz and Disney entered into an employment agreement under which Ovitz would serve as Disney's president for five years. Ovitz only served the position for slightly over one year before Disney terminated Ovitz in December 1996. But under the terms of the employment agreement, Disney paid Ovitz a total severance payout valued at approximately $130 million.[42] In January 1997, several Disney shareholders quickly brought derivative actions in the Delaware Court of Chancery. One central claim of these shareholders' lawsuits was that the Disney board of directors breached its fiduciary duty to the shareholders when the board inattentively approved the employment agreement with Ovitz. These litigations have lasted for ten years, and the Supreme Court of Delaware affirmed in June 2006 the Chancery Court's judgment in favor of Disney's board. Although two of Disney's largest

[42] *In re* the Walt Disney Co. Derivative Litig., 906 A.2d 27, 35 (Del. 2006) (*Disney III*). In this paper, I will also cite to the two Walt Disney opinions issued by Chancellor Chandler in the trial court, to which I refer as *Disney I* and *Disney II*, respectively.

individual shareholders supported the hiring decision,[43] the litigations have exposed how a major American corporation's board "ordinarily" performs its monitoring role on behalf of the shareholders, even though the majority of the board's directors were independent.

In approving to hire Ovitz and to enter the employment agreement, Disney's board basically followed all of the directions by Michael Eisner, Disney's then CEO for over ten years. After Disney had lost in a tragic helicopter crash its former president, Eisner began to search for a successor. His primary candidate for the position was Ovitz, with whom Eisner had enjoyed a social and professional relationship for nearly twenty-five years. Initially, Eisner expressed his desire to hire Ovitz with the board members on an individual basis.[44] Under Disney's charter, the board was responsible for selecting the corporation's officers, and a compensation committee was responsible for establishing and approving salaries for the officers.[45] Disney's board was composed of fifteen members at that time, eleven of whom qualified as independent directors.[46] The compensation committee had four members, three of whom qualified as independent. Accordingly, both the board and the compensation committee were composed of a majority of independent directors. The non-independent compensation committee member was Irwin E. Russell, who was also Eisner's personal attorney. Eisner and Russell were primarily responsible for negotiating the terms of the employment

[43] *See* 906 A.2d at 36 n.4, 39 n.10 (Roy Disney and Sid Bass were the two large shareholders who supported the hiring decision).
[44] 906 A.2d at 36.
[45] *Id.* at 53.
[46] *See In re* Walt Disney Co. Derivative Litig., 731 A.2d 342, 356-61 (Del. Ch. 1998) (*Disney I*). The Delaware Chancery Court considered a director to be independent if that director can exercise his or her business judgment independent of the CEO's influence. According to this definition, the court concluded that twelve of the directors were independent. But one of these twelve directors, Roy E. Disney, was also a top executive at Disney. Accordingly, when an independent director is defined as "one who has no financial interest in the firm other than the director's retainer fee," Roy E. Disney does not qualify as an independent director.

agreement with Ovitz. They later brought in one of the three independent compensation committee members, Raymond Watson, to evaluate a proposed compensation package for Ovitz. After these members reached an agreement with Ovitz, they contacted by phone the rest of the two compensation committee members to inform them the hiring decision and the terms of the employment agreement. Eisner also informed each of the rest board members by phone. The compensation committee then formally approved the employment agreement during its one-hour meeting, during which the committee also considered other agendas. Each committee member received a term sheet at this meeting, but not a draft of the employment agreement. Immediately after the compensation committee meeting, the Disney board met. Eisner led the discussion regarding Ovitz, and Watson and Russell responded to questions from the rest of the board. The board then formally voted unanimously to elect Ovitz as Disney's new President.[47]

Ovitz's tenure at Disney was brief. In September and November 1996, Eisner informed the board during board meetings of the continuing problems with Ovitz's performance. Around the same time, Eisner worked with Disney's general counsel to consider whether Disney could dismiss Ovitz for cause, in which case Disney would not be obligated to pay the $130 million severance to Ovitz under the employment agreement. But Eisner and the general counsel found that they could not dismiss Ovitz for cause. Eisner then announced Ovitz's termination to the public through a press release. Before the press release was issued, Eisner attempted to inform each of the board members by telephone of the decision. None of the board members objected to Ovitz's termination. According to the Chancery Court, "[a]lthough the board did not meet to vote on the termination, . . . most, if not all, of the Disney directors trusted

[47] 906 A.2d at 39-41.

Eisner's and [the general counsel's] conclusion that there was no cause to terminate Ovitz, and that Ovitz should be terminated without cause even though that involved making the costly [severance] payment."[48]

Disney's shareholders who brought the lawsuits unsuccessfully argued that the compensation committee members breached their fiduciary duty by approving the employment agreement with Ovitz. The Delaware court reviews a board's decision under the business judgment standard. Under this standard, the law presumes that "in making a business decision the directors of a corporation acted on an informed basis, in good faith, and in the honest belief that the action taken was in the best interests of the company."[49] A plaintiff can rebut the presumption if "the plaintiff shows that the directors breached their fiduciary duty of care or of loyalty or acted in bad faith."[50] The court adopts a gross negligence standard for the duty of care determination. Although the court acknowledges that in approving the terms of the employment agreement, the compensation committee did not follow the "best practices," the court refused to find that the compensation committee acted in gross negligence. According to the court, even though not every member of the committee reviewed the draft of the employment agreement, each member was informed of the substance of the agreement either orally through other members or through the term sheet.[51] Thus, because "the committee had adequately informed itself of the potential magnitude of the entire severance package," the committee did not breach its duty of care. Because the shareholders also

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[48] *Id.* at 45.
[49] *Id.* at 52.
[50] *Id.*
[51] *Id.* at 58.

unsuccessfully argued that the committee members had acted in bad faith[52] and did not argue that the members had breached their duty of loyalty, the compensation committee's decision is protected under the business judgment standard[53].

The shareholders' challenge to the board's hiring decision was similarly unsuccessful. According to the court, because the directors were informed of all the information reasonably available concerning Ovitz's hiring, the directors were not grossly negligent in approving the hire.

Perhaps the hiring decision was in fact an unfortunate mismatch between Ovitz and Disney, not the result of the board's negligence, the Disney litigations nevertheless provide for us a valuable insider look into the operations of a major American corporation's board, a board with a majority of independent directors. Michael Eisner, the CEO, was the driving force for the hiring decision and negotiations concerning the employment agreement. Once Eisner made up his mind, he only had to contact the rest of the board members individually through telephone to secure their support. Once Eisner had informed these board members by phone, both the compensation committee's formal approval and the board's formal unanimous vote were exceedingly brief. But the business judgment standard protects a board's decision from judicial scrutiny as long as the board members made an informed decision. The board adequately informs itself, according to the Delaware court, even though the executives bring the information informally to the board and the board never even deliberates the information.

[52] In making the bad faith determination, the Delaware Supreme Court approved the Chancery's definition of bad faith. Under this definition, the "intentional dereliction of duty, a conscious disregard for one's responsibilities, is an appropriate (although not the only) standard for determining whether fiduciaries have acted in good faith." 906 A.2d at 62.
[53] *Id.* at 58.

Moreover, the Disney board's composition confirms the academic findings that the executives often choose the board members, including independent board members. As discussed above, at the time when the board approved to hire Ovitz, eleven of the board's fifteen members qualified as independent directors. Of these eleven independent directors, the Delaware court cited at least five that had maintained personal relationships with Eisner outside of their directorship: Two were Disney's retired executives; one was the president of Georgetown University, which had received over $1 million donations from Eisner; one was a counsel to a law firm retained by Disney; and one was the principal of the elementary school where Eisner's children had attended. Through these relationships, we can understand how these directors could have paid natural deference to Eisner.

ii. Worldcom

Worldcom's accounting scandal in 2002 has shocked the world and led to major changes in accounting, business, and legal communities. Unlike the Enron scandal discussed below, Worldcom, under the leadership of its then CEO, Bernard Ebbers, had engaged in outright fraud from 1999 to 2002. It underreported its major costs by capitalizing these costs instead of expensing them. It also inflated revenues with bogus accounting entries. Overall, Worldcom had inflated its total assets by approximately $11 billion through fraud. While these frauds lasted for over three years, Worldcom's board of directors appeared to have been completely ignorant of the fraud.

The ignorance of Worldcom's board was due to the board's passivity and the strong dominance of Ebbers over the board. Ebbers co-founded Worldcom's predecessor in 1983 and grew Worldcom through a series of acquisitions in the 1990s. During most of the period when Worldcom committed frauds, the board had fifteen members.[54] Except for Ebbers and Scott Sullivan, Worldcom's then CFO, the rest thirteen members all qualified as independent directors. Almost all of these thirteen independent directors were individuals who had been owners, officers, or directors of companies Worldcom had acquired in the past.[55] These Worldcom directors received both cash and stock options, with overall compensation heavily weighted toward the latter.[56] For cash compensation, the directors received a fixed annual retainer fee of $35,000 plus fees for each board or committee meeting attended. Besides stock option compensation, many directors owned significant amounts of Worldcom stock because these directors had held substantial stakes in companies acquired by Worldcom. The board conducted most of its functions as a formality. It held regular meetings between four and six times a year and special meetings as needed. The meetings followed a consistent format, and Ebbers dominated all the meetings.[57] Each meeting opened with a prayer followed by a series of presentations. Then the chairman of each special committee reported on its committee issues. The meetings discussed financial matters at high level. But according to the Special Investigative Committee of the Board of Directors of Worldcom—formed by Worldcom's new board after the scandal—these high-level discussions of financial matters were consistent with the practice at most boards during the same period. Each of the special committees apparently adopted a "hand-off" approach to their commitments,

[54] SPECIAL INVESTIGATIVE COMMITTEE OF THE BOARD OF DIRECTORS OF WORLDCOM, INC., REPORT OF INVESTIGATION 265 (2003), *available at* http://fl1.findlaw.com/news.findlaw.com/hdocs/docs/worldcom/bdspcomm60903rpt.pdf.
[55] *Id.* at 264-65.
[56] *Id.* at 266.
[57] *Id.* at 267.

largely adopting recommendations by Ebbers.[58] The Special Investigative Committee summarized the board's role as the following:

> The Board of Directors does not appear to have known of the fraud, nor did it receive information we believe should have put it on notice. However, the Board was so passive and reliant on Ebbers and Sullivan that it had little opportunity to learn of the fraud. . . . The outside Directors had little or no involvement in the company's business other than through attendance at Board meetings. . . . [They] had virtually no interaction with Company operational or financial employees other than during the presentations they heard at meetings. While in this respect the Directors were far from unique among directors of large corporations, this lack of contact meant that they had little sense of the culture within the Company, or awareness of issues other than those brought to them by a few senior managers. . . .
>
> Ebbers was autocratic in his dealings with the Board, and the Board permitted it. With limited exceptions, the members of the Board were reluctant to challenge Ebbers even when they disagreed with him. They, like most observers, were impressed with the Company's growth and Ebbers' reputation, although they were in some cases mystified or perplexed by his style. This was Ebbers' company.[59]

While Worldcom's accounting fraud may have been one of the few unfortunate incidences among the country's numerous corporations, Worldcom board's passivity in performing its monitoring role is far from unique, as the Special Investigative Committee's report frequently notes. But for the general norm requiring a board of directors, Worldcom may not have even needed a board. After all, the board appeared to have provided no value to the corporation or to the shareholders and instead caused the corporation to spend money on its valueless formality.

[58] *See id.* at 272.
[59] *Id.* at 7, 30-31, 32.

iii. Enron

Enron's accounting scandal sent similar shockwaves throughout the world. Unlike Worldcom's outright accounting fraud, Enron engaged in a series of convoluted and questionable high-risk accounting practices to conceal its debts and to boost its assets. While Worldcom's fraud had caused its demise, it is not clear whether the fraud had caused Enron's demise or Enron's aggressive business model had caused its fraud. In the 1990s, Enron had transitioned from a traditional energy company with pipelines and power plants to a high-tech enterprise that traded energy contracts.[60] Trading energy contracts exposed Enron's assets to risk fluctuations. In order to avoid the fluctuations from affecting Enron's credit rating, Enron established a series of affiliated companies to own its debts. But Enron would own less than 50% of these entities so that Enron would not need to consolidate these entities' books. By 2000, Enron had lodged $27 billion debts in these unconsolidated affiliates. Also unlike the Worldcom fraud, of which the Worldcom board appeared to be ignorant, the Enron board was aware of and approved these accounting schemes, even though the board members claimed that they did not consider the schemes to be fraudulent. According to several Enron's directors, they knew that "the company was engaged in high-risk and innovative transactions" and that "Enron was engaged in complex accounting and was operating in areas with few established accounting guidelines."[61] Thus, because the directors thought that Enron "was engaged in business transactions that had 'not been done by many companies in the world' and

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[60] PERMANENT SUBCOMMITTEE ON INVESTIGATIONS OF THE COMMITTEE ON GOVERNMENTAL AFFAIRS, THE ROLE OF THE BOARD OF DIRECTORS IN ENRON'S COLLAPSE 6 (2002).
[61] *Id.* at 20.

were ‘relatively new,’” they did not consider the accounting schemes to be questionable.[62]

Superficially, Enron’s board maintained a number of practices that a Delaware court would consider to be “best practices.” It had fifteen members, many of whom served on the boards of other companies. Former Chairman of Enron’s Executive Committee described members of the board as well educated, “experienced, successful businessmen and women,”[63] and “experts in areas of finance and accounting.”[64] One of the directors was a former dean and an accounting professor at the Stanford Business School.[65] All of the directors described internal board relations as harmonious. They could recall only two instances over the course of many years when board votes were not unanimous. They also described a good working relationship with Enron management because the directors possessed great respect for senior Enron officers, trusting the integrity and competency of the officers who were later indicted.[66] The board was organized into five committees. One of the committees was the Audit and Compliance Committee, which reviewed Enron’s accounting and compliance programs and approved Enron’s financial statements and reports. The board normally held five regular meetings per year, with additional special meetings as needed. Each board meeting usually lasted two days, during which the committees also held meetings. During the committee meetings, Enron management generally provided presentations on a variety of company issues. Enron also organized trips abroad during which board members viewed company assets and operations. But overall, the board members maintained a routine contact with

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[62] *Id.*
[63] Only one of the fifteen board members was a woman. *Id.* at 1.
[64] *Id.* at 8.
[65] *Id.* at 2.
[66] *Id.* at 8.

less than a dozen senior officers at Enron.[67] Each board member was compensated with cash and stock. The total cash and equity compensation of Enron board members in 2000 was about $350,000, more than twice the national average for board compensation at a U.S. publicly traded corporation.[68]

Unlike the Worldcom board, which had a strong CEO who often intimidated the rest of the board, Enron's board did not appear to have had such a dominant figure. But at the end of the day, the board relied on what the executives informed them, relied on the perceived "integrity" and "capability" of the executives, and relied on the "clean" audit opinions from Enron's auditor, Arthur Andersen.[69] The U.S. Senate's Subcommittee found extensive evidence that shows the board was aware that Enron was engaged in questionable accounting practices. But Enron directors apparently never challenged the executives' decisions even when the directors received alarming information. For example, when Enron created a series of special purpose entities to own Enron's debts, Enron had to have "unaffiliated" people to own these entities. Instead of finding a truly independent investor, Enron's CFO or the CFO's subordinates owned the entities. Even though each entity involved hundreds of millions of Enron's investment, the directors did not feel troubled by the conflicts of interest posed because they relied on the executives to develop and implement the day-to-day controls. The directors were satisfied with their infrequent and generalized reviews about these entities, guided by the executives' presentations.[70] After one of the special entities had operated for more than one year, the Compensation Committee sought to review the CFO's compensation from the special

[67] *Id.* at 10.
[68] *Id.* at 11.
[69] *Id.* at 14.
[70] *Id.* at 29.

entity. The Chairman of the Compensation Committee requested this information from Enron's senior compensation officer, but the officer failed to deliver for more than one year, until the Wall Street Journal published the compensation. During this one year, no other board member took steps to obtain the information.[71]

Not only did the Enron board rely on the executives, they probably also relied on each other. The board's large size filled with highly experienced business people aggravated the collective action problem. Perhaps each of them thought the following: "If Famous Person One is not challenging the transaction, why should I be concerned and break the harmonious atmosphere that has long existed in the boardroom?" A large board filled with highly paid and highly successful people may have appeared impressive to the outside world, but in reality may have been a detriment to shareholders. Such a prestigious board not only costs significantly more money to maintain but is also much more inefficient to operate. The board probably did not contribute to Enron's initial success since Enron's executives probably created Enron's business models. In this sense, the board's sophistication may have simply been a façade, constructed with a hefty price to conceal its true uselessness. The five separate committees within the board all had fancy names. But if all they did was to passively approve the executives' proposals, a board may have performed a far superior job if it had only three ordinary business people, instead of highly successful ones. Suppose board jobs for publicly traded corporations do not belong exclusively to a small community of elite members, and ordinary workers would compete based on their abilities and dedication in order to serve on a board. This open competition for board jobs would be more likely to produce more efficient and active boards.

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[71] *Id.* at 35.

III. Suggestions for the State Law to Improve Boards' Monitoring

According to Professors Bhagat, Carey, and Elson, Delaware courts' decisions favoring independent and disinterested directors "have led not to more effective management oversight but, instead, to a classic triumph of form over function – where, although prescribed procedure has been followed, decisionmaking appears to be little more than staged play-acting, absent critical engaged oversight."[72] Boards of directors at Disney, Worldcom, Enron, and countless others have confirmed these professors' statement. Court reviews of challenged corporate decisions in Delaware have generally focused on a narrow set of transactions and sought to require boards to adopt procedural safeguards only for these transactions. Because of this focus on certain transactions instead of on the broader board operation in general, Delaware law has not been effective at improving board passivity. Instead, boards react with costly procedures only to circumvent the court's scrutiny for this narrow set of transactions. On the other hand, federal encroachment into state law, such as the SOX legislation, not only has no positive effect in corporate boards but also intrudes into an area of state law whose flexibility has been one of American law's geniuses. In this section, I first briefly summarize why the SOX legislation is unlikely to bring positive changes to the board room. I then propose that the Delaware courts continue its current wave of enhancing the good faith jurisprudence by applying the doctrine broadly to the general board operation instead of focusing solely on the particular board transaction that's the subject of litigation.

A. Sarbanes-Oxley Act: Costly but Fruitless Federal Legislation

Partly because of the inadequate safeguarding provided by state law, the federal government, in response to the market outcry over Enron, Worldcom, and a series of

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[72] Bhagat et al., *supra* note 3, at 17.

other scandals at large corporations, hurried in and produced SOX. But as Professor Romano convincingly argues, the procedure imposed by SOX is unlikely to bring any positive effect for corporate governance.[73] A central mandate of SOX is the requirement that all publicly traded companies must have audit committees composed entirely of independent directors.[74] Such an independent audit committee is unlikely to be effective but extremely costly. Professor Romano summarizes in her article a large number of literatures examining the impact of the audit committee's independence on firm performance and on financial statement misconduct.[75] The compelling conclusion from these literatures is that requiring audit committees to consist solely of independent directors will not reduce the probability of financial statement wrongdoing or improve firm performance.[76]

The discussion in Section II.B and the Disney, Worldcom, and Enron examples help explain why audit committees with solely independent directors will not achieve what Congress intended. Arguments in favor of independent directors assume that these directors are less likely to defer to the executives and accordingly more likely to find out wrongdoings and provide more monitoring than inside directors. But Worldcom and Enron's boards failed to adequately monitor the executives not because the directors were not independent, but because directors have a natural tendency to stay passive and to defer to the executives' decisions. Independent directors, contrary to what Congress wants to believe, are actually more likely to stay passive than inside directors. They are not full-time corporate employees and most likely do not depend on the corporation's

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[73] Romano, *supra* note 12, at 1529-43.
[74] Sarbanes-Oxley Act § 301, 2002 U.S.C.C.A.N. (116 Stat.) at 775-77.
[75] Romano, *supra* note 12, at 1530-33.
[76] *Id.* at 1533.

success for their livelihood. Their compensation structure does not award them to spend more time than the fixed number of meetings they need to attend. Further, independent directors need to spend more time than inside directors to learn about the firm. Unless directors see clear evidence of wrongdoing or face an already exposed corporate crisis, they have a natural tendency to rely on the executives' representation. Moreover, people serve on audit committees not because they will be likely to arduously search for potential wrongdoings. Rather, directors will wish to develop a collegial, not adversary, relationship with the executives. After all, a director's job is much easier when he or she does not need to constantly challenge the executives. Therefore, even if independent directors on day one may not always say yes to the executives, over time, their initial alertness will gradually fade away. And "at the end of the day, most independent directors get neutralized in one fashion or another."

Not only will SOX not achieve what Congress intended, a further problem with SOX is that it encroaches into a regulatory regime that had long belonged to the states. The "genius of U.S. corporate law," prior to SOX, had been that "corporations can choose their legal regime from the 50 states and the District of Columbia."[77] If one state's law creates a substantial burden on a firm, the firm will simply incorporate in a different state. Moreover, as discussed in Section II.A, different firms require different board structures to best fit the particular firm's business and special demand. Under a uniform federal statute, firms have no easy way to escape, even if the statute is extremely inefficient, unless these firms choose to delist.

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[77] Romano, *supra* note 16, at 313.

B. A Proposal to Delaware Courts: Expand the Good Faith Review

Absent changes at the state level, Congress, however, may not be willing to repeal SOX. After all, SOX is Congress's response to a spate of accounting scandals that shattered public confidence in the securities market. Although it is a poor means to an end, the threat of a negative political image may cause Congress hesitant to admit its fault in the short term. At the same time, the gap between corporate reality and state law's assumptions leaves most people unsatisfied with the current form of corporate governance. Perhaps judicial oversight alone is insufficient to transform corporate governance, but law's insistence in a certain direction can and in fact often does lead to positive changes in people's behavior. Delaware is the pioneer and leader in corporate law. Delaware courts, for the most part, have restrained themselves from "intervening" into corporate business decisions. From time to time, when corporate scandals loom in the public mind, Delaware courts do react to strengthen their oversight of the board. For example, during the acquisition frenzy period in 1980s, Delaware courts issued a series of opinions, imposing various procedures and duties in the merger and acquisition area. In recent years, commentators have noticed that the Delaware courts have not been completely unresponsive to the spade of accounting scandals. The emphasis on "good faith" in the *Disney* opinions suggests that Delaware judges are eager to develop a suitable judicial doctrine to enhance their oversight over board conduct without unduly interfering with corporate business matters. In this subsection, I propose that the Delaware court adopts an expansive good faith review for overall board operations instead of focusing solely on the particular board decision that leads to the litigation. The "good faith" doctrine is particularly suitable to take into account the three negative factors identified in this paper that affect board monitoring – board members' conflict of interest, their collective action problem, and executives' entrenchment incentive over board members.

Subsection III.B.i lays out the expansive good faith evaluation that I propose. This subsection also briefly describes the business judgment rule and the main justifications for this rule. In the following two subsections, I explain why the expansive good faith evaluation will not interfere with these justifications for the business judgment rule. In the last subsection, I apply the expansive good faith evaluation to the Disney example described in subsection II.C.i above.

i. The Good Faith Exception to the Business Judgment Rule

Under Delaware law, board directors traditionally face two types of fiduciary duties: the duty of loyalty and the duty of care.[78] The duty of loyalty mainly deals with self-dealing transactions. It requires a corporate director or officer who enters a transaction with the corporation to "fully disclose all material facts to the corporation's disinterested representatives and to deal with the company on terms that are intrinsically fair in all respects."[79] The duty of care requires a director to perform his or her functions (1) in good faith, (2) in a manner the director reasonably believes to be in the best interests of the corporation, and (3) with the care that a person in a like position would reasonably believe appropriate under similar circumstances.[80] Although the duty of care standard reads similar to an ordinary negligence standard in tort law, courts have long introduced the business judgment rule to insulate directors' performance from judicial

[78] Cede & Co. v. Technicolor, Inc. 634 A.2d 345, 367 (Del. 1993); Sean J. Griffith, *Good Faith Business Judgment: A Theory of Rhetoric in Corporate Law Jurisprudence*, 55 DUKE L.J. 1, 9 (2005).
[79] WILLIAM T. ALLEN & REINIER KRAAKMAN, COMMENTARIES AND CASES ON THE LAW OF BUSINESS ORGANIZATION 285 (2003).
[80] RMBCA § 8.30.

scrutiny in most situations. Under the business judgment rule, the law presumes that "in making a business decision the directors of a corporation acted on an informed basis, in good faith, and in the honest belief that the action taken was in the best interests of the company."[81] Courts and scholars have identified two principal justifications for the business judgment rule: (1) a negligence standard deters risk-taking by corporate officers and directors, a situation that shareholders do not prefer;[82] and (2) judges are not business experts.[83] In addition to these two justifications, Professor Bainbridge, a strong proponent of the business judgment rule, has identified an additional justification: judicial review of business decisions could "interfere with—or even destroy—the internal term governance structures that regulate board behavior."[84]

Significantly, to allow the business judgment rule to apply, a director must have acted in good faith. A plaintiff can rebut the business judgment presumption by showing that a director breached the duty of care or duty of loyalty, or the director acted in bad faith.[85] If the plaintiff successfully rebuts this presumption, the burden shifts to the director defendant "to demonstrate that the challenged act or transaction was entirely fair to the corporation and its shareholders."[86] This good faith requirement is codified in several provisions of the Delaware General Corporation Law (the "DGCL"). Under Section 102(b)(7) of the DGCL, Delaware corporations can exculpate their directors, in

[81] Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984); *Disney III*, 906 A.2d 27, 52 (Del. 2006).
[82] *See Gagliardi v. Trifoods International, Inc.* 683 A.2d 1049, 1052 (Del. Ch. 1996) ("Shareholders can diversify the risks of their corporate investments. Thus, it is in their economic interest for the corporation to accept in rank order all positive net present value investment projects available to the corporation, starting with the highest risk adjusted rate of return first. Shareholders don't want (or shouldn't rationally want) directors to be risk averse.").
[83] This justification first appeared in *Dodge v. Ford Motor Co.*, 170 N.W. 668 (Mich. 1919).
[84] Stephen M. Bainbridge, *The Business Judgment Rule as Abstention Doctrine* (Univ. of Cal., Los Angeles Sch. of Law Law & Econ. Research Paper Series, Paper No. 03-18), *available at* http://ssrn.com/abstract=429260.
[85] *Disney III*, 906 A.2d at 52.
[86] *Id.*

their charter provisions, from monetary liability for a breach of the duty of care, provided that the directors acted in good faith. Section 145 of the DGCL allows Delaware corporations to indemnify directors for the costs and outcomes of litigation, provided that the directors acted in good faith. Prior to the *Disney* litigations, this good faith requirement occurred in case law only occasionally. In *Cinerama, Inc. v. Technicolor, Inc.*, the Delaware Supreme Court specifically referred to a director's "triad of fiduciary duties": "to rebut the [business judgment] presumption, a shareholder plaintiff assumes the burden of providing evidence that the board of directors, in reaching its challenged decision, breached any one of its triad of fiduciary duties: good faith, loyalty, or due care."[87] Scholars have counted at least a dozen Delaware cases, decided prior to *Disney*, that adopted the "triad of fiduciary duties."[88] However, Delaware courts had not extensively addressed the exact meaning of good faith until in *Disney*.

In the *Disney* litigations, the issue of good faith played a prominent role.[89] In the trial court, Chancellor Chandler referred to the good faith issue in the negative and asked whether the directors had acted in bad faith. Chancellor Chandler then went on to define bad faith:

> Upon long and careful consideration, I am of the opinion that the concept of intentional dereliction of duty, a conscious disregard for one's responsibilities, is an appropriate (although not the only) standard for determining whether fiduciaries have acted in good faith. Deliberate indifference and inaction in the face of a duty to act is, in my mind, conduct that is clearly disloyal to the corporation. It is the epitome of faithless conduct.[90]

[87] Cinerama, Inc. v. Technicolor, Inc. 663 A.2d 1156, 1164 (Del. 1995).
[88] *See* Charles Hansen, *Sowing the Seeds of Confusion: The Ephemeral Triad*, 73 ASPEN L. & BUS. CORP. 1, 2 (2002); Melvin A. Eisenberg, *The Duty of Good Faith in Corporate Law*, 31 DEL. J. CORP. L. 1, 12 (2006).
[89] *Disney III*, 906 A.2d at 63.
[90] *Disney II*, 907 A.2d at 755.

On appeal, the Delaware Supreme Court provides three categories of fiduciary behavior as "candidates for the 'bad faith' pejorative label".[91] The first category "involves 'subjective bad faith,' that is, fiduciary conduct motivated by an actual intent to do harm."[92] The court refers to this conduct as the "classic, quintessential bad faith."[93] The second category is the most confusing because the conduct "involves lack of due care-that is, fiduciary action taken solely by reason of gross negligence and without any malevolent intent."[94] The court took pain to explain that in a psychological sense, "the conduct that is the subject of due care may overlap with the conduct that comes within the rubric of good faith."[95] But as a legal matter, according to the court, the two standards are not the same. Thus, "grossly negligent conduct, without more, does not and cannot constitute a breach of the fiduciary duty to act in good faith."[96] Yet the court does not clarify what conduct in addition to gross negligence constitutes bad faith. The third category of conduct not in good faith, according to the supreme court, is the type defined by Chancellor Chandler, i.e., "intentional dereliction of duty, a conscious disregard for one's responsibilities."[97] Different wordings aside, the third category appears to be a specific example of the second category. When directors consciously disregard their responsibilities, their conduct should also have been grossly negligent. Thus, this "conscious disregarding" attitude appears to be the extra behavior on top of gross negligence that makes the conduct not in good faith.

[91] *Disney III*, 906 A.2d at 64.
[92] *Id.*
[93] *Id.*
[94] *Id.*
[95] *Id.* at 65.
[96] *Id.*
[97] *Id.* at 66.

Although the Delaware Supreme Court attempted to provide "some conceptual guidance to the corporate community" through the above analysis, the court's three categories are far from clear. Perhaps as Professor Griffith argued, this focus on good faith in recent Delaware cases is simply rhetoric in Delaware corporate law jurisprudence in response to the scandals in recent years.[98] According to Professor Griffith, the good faith analysis "operates as a speech act, a performance, as opposed to a careful method of analysis."[99] Once the crisis and scandals fade away in the public mind, Professor Griffith predicts that the court will return to the old position of board deference.[100]

However, to recapture Delaware's dominance in corporate law from the federal intrusion and to establish the law's positive role in shaping corporate governance, Delaware judges should not treat this "good faith" analysis as temporal rhetoric in crisis time. Instead, the duty of good faith should be expanded to cover problematic board conduct that falls outside the traditional duties of care and loyalty. As discussed in Part II, boards have a tendency to stay passive because (1) directors have a conflict of interest, i.e., loyalty to the executives, not shareholders; (2) directors have their own collective action problem among themselves; and (3) executives have a natural tendency to entrench the board. Neither the traditional duty of care nor duty of loyalty analysis addresses these issues because the traditional analysis focuses on a specific board action or inaction that's the subject of litigation. Surely directors for publicly traded companies have a busy life and have to consider a variety of different agendas for the firm. The business judgment rule prevents judges from falling into the hindsight bias. Without the business judgment

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[98] *See* Sean J. Griffith, *Good Faith Business Judgment: A Theory of Rhetoric in Corporate Law Jurisprudence*, 55 DUKE L.J. 1 (2005).
[99] *Id.* at 1.
[100] *Id.* at 2.

rule, a judge may, ex post, require directors to have considered one business decision more thoroughly than others just because this decision turned out to become the subject of litigation. Accordingly, judges impose a low threshold for directors to pass their fiduciary duty obligations – a board decision passes muster as long as directors made the decision on an informed basis and in good faith. And a director only needs to "know the facts" to be able to make a decision on "an informed basis."

Instead of focusing on a specific transaction in dispute, I propose that the court expands its review of board operations by examining how the board generally performs its monitoring role. The court should allow plaintiffs to show, under the good faith prong, that the board has been operating in a way so passive that the board almost always casually disposes all the corporate matters or defers to the executives. Because the board in general casually performs its monitoring role, it could not have properly deliberated the particular board decision in dispute. In this situation, the business judgment presumption does not apply, and the burden shifts to the defendant to prove that the particular board decision in the dispute was fair to the corporation and to the shareholders.[101] This expansive review for board operations also fits in Chancellor Chandler's "intentional dereliction of duty, a conscious disregard for one's

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[101] Note that this test is more expansive than the tests in *Graham* and *Caremark*. In *Graham v. Allis-Chalmers Manufacturing Co.*, 188 A.2d 125 (Del. 1963), the corporation and four of its mid-level managers pled guilty to price-fixing charges, causing big fines imposed on the corporation. Corporate shareholder brought a derivative suit against directors and top officers, alleging that the directors and officers failed to take actions designed to learn of and prevent such anti-trust violations by corporate employees. The court held that the directors were not liable because the plaintiffs had shown no evidence that had put the directors on notice that employees had engaged in conduct violating antitrust laws. In *In re Caremark International Inc. Derivative Litig.*, 698 A.2d 959 (Del. Ch. 1996), lower-level officers engaged misconduct violating the Anti-Referral Payments Law that cost $250 million fines to the corporation. Although the court found that the directors have an obligation (an affirmative duty) to insure the corporation's reporting system is adequate, the court did not find that the directors were liable because the corporation's information systems appear to have represented a good faith attempt to be informed of the relevant facts from its employees. In both *Graham* and *Caremark*, the courts still focused on only the boards' inaction surrounding the particular misconduct that damaged the corporation. The courts in those two cases did not look at the boards' operation in general, beyond the damaging misconduct.

responsibilities" test. After all, if board directors in general disregard their responsibilities, they could not have thoroughly considered the particular board action in dispute.

Under this expansive board review, the court should examine board operations both on an individual director's basis and on the whole board. On an individual director's basis, the court should ask how, in general, each board director has performed his or her monitoring role and has approved major business decisions. For example, the court should examine the time and effort each director devotes into the firm's business; how much each director knows about the firm and the matters he or she had to decide; how each director approves a transaction; and whether a director always blindly follows the executives' recommendation or his or her colleagues' lead without providing independent input.

To the board as a whole, the court should evaluate the overall atmosphere within the board and be sensitive to the executives' entrenchment tendency. Chancellor Chandler acknowledges in *Disney* that the good faith prong is particularly suitable when a corporation is governed by an "imperial CEO":

> It is precisely in this context -- an imperial CEO or controlling shareholder with a supine or passive board -- that the concept of good faith may prove highly meaningful. The fiduciary duties of care and loyalty, as traditionally defined, may not be aggressive enough to protect shareholder interests when the board is well advised, is not legally beholden to the management or a controlling shareholder and when the board does not suffer from other disabling conflicts of interest, such as a patently self-dealing transaction. Good faith may serve to fill this gap and ensure that the persons entrusted by shareholders to govern Delaware corporations do so with an honesty of purpose and with an understanding of whose interests they are there to protect.[102]

[102] *Disney II*, 907 A.2d at 761.

Without evaluating the general atmosphere at the board and looking beyond the particular transaction in dispute, the court may not have sufficient evidence to be able to label a dominant executive as the "imperial CEO." When evaluating overall board operations, the court should focus on how the executives in general approach board members. For example, does the board have an executive so dominant that the directors regularly have been unable or unwilling to challenge the executive? Does the executive normally approach and inform the board on an individual basis or on a collective basis? Does the executive constantly play politics around board members, attempting to tailor to individual directors' personal interest in order to achieve what the executive desires? Is the board's atmosphere professional and conducive to productive decisionmaking? Taking these factors into consideration will help curtail executives' entrenchment tendency. Although judges do not wish to mandate how the board conducts its business, evaluating the board's general atmosphere does not intrude into directors' decisionmaking but may push boards into building a more active and productive environment.

ii. An Expansive Good Faith Evaluation Is Not Counterproductive

Allowing the plaintiffs to show board passivity beyond the transaction in dispute should not deter directors' risk-taking or discourage qualified individuals from serving on the board. One of the main justifications for the business judgment rule is that judicial challenge to directors' decisions ex post deters directors' risk-taking. Corporate officers and directors invest other people's money. Shareholders can eliminate firm specific risk by diversifying their portfolio so they prefer optimal risk-taking by corporate officers and directors.[103] In the absence of the business judgment rule, corporate officers and directors would bear the full costs of the downside of a risky project, but they would receive only a small fraction of the gains from the upside of the risky project.[104] Accordingly, judges have invoked the business judgment rule to prevent themselves from falling into the inevitable hindsight bias when second-guessing a corporate decision. A more expansive good faith evaluation, however, should not deter directors' risk-taking any more than the current transactional approach. Under the expansive approach, judges do not scrutinize more thoroughly than under the current approach for the particular board decision in dispute. Instead, judges simply expand the horizon, looking beyond the transaction and evaluating the board operation in general. The weakness under the transactional approach is that it isolates one transaction from the board's overall operation. When the board considers a business matter ex ante, it may not know exactly how the decision will affect the business. Or the board may have reasonably overlooked the importance of its decision – the decision may turn out to be more important than the board initially considered. Thus, unless the plaintiffs bring strong evidence of directors' self-dealing or gross negligence in this one transaction, the plaintiffs are unlikely to succeed in their claims. Facts surrounding one transaction often are too limited to prove that the directors have "consciously disregarded" their duties. Under the expansive good faith evaluation, however, if the pattern of the board operation shows that the directors almost always casually dispose their duties and always blindly follow the executives' recommendations, then the plaintiffs may succeed in their claims. Corporate boards consider a variety of business matters. Without showing how the board operates over a

[103] *See* Gagliardi, 683 A.2d 1049, 1052; Bainbridge, *supra* note 84, at 31.
[104] ALLEN & KRAAKMAN, *supra* note 79, at 241.

number of matters, plaintiffs can hardly show that the board has “consciously disregarded” its duties. At the same time, judges still do not impose their own business ideas when evaluating the board’s overall operation. Judges will simply evaluate whether the pattern of board operation demonstrates that it was passive or active. Thus, this expansive good faith evaluation should not deter directors’ risk-taking.

Moreover, the expansive good faith approach should not deter qualified individuals from serving on the board. On the contrary, qualified individuals may have more incentive to serve as directors under the expansive approach than under the transactional approach. Judges are more likely to respect a director’s decision when the director consistently and diligently serves his or her monitoring role, even if one unfortunate decision resulted in significant losses. Furthermore, because judges under the expansive approach are particularly sensitive to the general atmosphere at the board and the entrenchment tendency of the executives, corporate boards may have more pressure to develop into an active and productive environment. Qualified individuals should be more encouraged to serve on a board that treasures each board member’s input rather than one that blindly defers to the executives. Under the expansive approach, corporate boards may actually have the incentive to evaluate their own monitoring behaviors on a regular basis. On the other hand, a qualified individual may and should hesitate to serve on a board similar to the Worldcom board described above. The Worldcom board played virtually no role in the company’s success or failure. It had an “autocratic” CEO, and directors almost never challenged him. Certainly that board did not treasure any of its director’s expertise, and if the court adopts the expansive good faith review, individuals serving on that type of board should have felt uncomfortable about failing their fiduciary duties.

Professor Bainbridge has argued for an additional justification for the business judgment rule: judicial review of business decisions could interfere with the board's internal dynamics. He argues that the board of directors is a relational team and that members of this team "develop idiosyncratic working relationships with one another."[105] The team also develops its specific human capital and idiosyncratic internal review and monitoring processes for its members.[106] Judicial review of board decisions, according to Professor Bainbridge, may "destroy the interpersonal relationships that foster these forms of internal board governance."[107] He further argues that the board's internal dynamics theory explains the "inapplicability of the business judgment rule to fraud or self-dealing."[108]

> When an individual director decides to pursue a course of self-dealing, however, he or she usually acts alone and, moreover, betrays his or her fellow directors' trust." It makes sense for courts to be less concerned with damage to internal team governance when the defendant director's misconduct has already harmed that governance structure through betrayal.[109]

The expansive good faith evaluation I propose is consistent with the board's internal dynamics theory Professor Bainbridge argues. A well functioned board with productive internal board governance is more likely to receive a judge's deference than a poorly operated board. The expansive good faith review should foster boards to develop and maintain its internal governance structure. Judges are more likely to appreciate a board's

[105] Bainbridge, *supra* note 84, at 44.
[106] *Id.* at 45-46.
[107] *Id.* at 46.
[108] *Id.* at 46.
[109] *Id.* at 45-47.

well established internal dynamics under the expansive good faith review than under the transactional approach. This is because, under the transactional approach, judges may have too limited facts to recognize the board's internal dynamics.

iii. Judges Are Well Suited to Evaluate Directors' Good Faith

The second main justification for the business judgment rule is that judges are not business experts. Perhaps many judges lack general business expertise and are ill equipped when having to dig through complex financial analysis, but Delaware chancellors often have significant prior corporate experience.[110] Moreover, as Professor Bainbridge points out, medical doctors and engineers do not receive similar deference as business people, and most judges do not have more medical or engineering experience than business experience. Thus, this business expertise rationale in reality is the same as the risk-averse rationale discussed above. "Reasonable minds may differ" given the same set of facts, so judges should not second-guess a well deliberated business decision, even if the decision turned out to be wrong. The expansive good faith evaluation I propose does not call upon judges to impose their own business opinions for the board decision in dispute. Instead, the good faith evaluation is more similar to a moral judgment valuation that judges frequently perform. Judges do not decide whether the particular business decision is correct or not. Instead, they focus on the entire board operation and general board atmosphere to see whether, given how the board in general performs its duties, the board has been so passive or an executive has been so dominant that virtually all of the board decisions are inadequately made.

One potential concern to the expansive good faith evaluation is that judges will be presented with far more evidence than under the current transactional approach. But if

[110] Bainbridge, *supra* note 84, at 40.

this approach will help corporate boards to become more active and their working relationship with the executives more productive, the additional cost is well wroth it. Both Chancellors Strine and Chandler have argued that the highly specific federal rules in SOX are an intrusion to the more flexible and "principles-based" state law.[111] They also admit that this federal encroachment into state law "may be due in part to the failure of Delaware law to respond with sufficient speed to changes in business practices."[112] Then accordingly, Delaware law should step up to deal with the board passivity problem rather than simply adding rhetoric only in times of crisis and scandals. Time will prove the SOX ineffective, which means a significant void still exists in our corporate law. Moreover, crisis and scandals accumulate during peaceful time. If the expansive good faith review pressures boards to properly govern their own monitoring role, this benefit is well worth the additional evidentiary cost to the courts.

iv. Application: Disney

In this subsection, I apply the expansive good faith evaluation that I propose to the Disney case described in Section II.C above. When performing the expansive good faith evaluation, besides focusing on Disney board's deliberation surrounding the hiring of Michael Ovitz, as Chancellor Chandler did in the Disney litigations, the court should also allow plaintiffs to show that the Disney board consistently disposed of its decisions quickly and casually by almost always following Eisner's direction. The court noted how swiftly the board approved the employment agreement with Ovitz – (1) Eisner and his personal attorney were primarily responsible for negotiating the terms of the employment

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[111] Griffith, *supra* note 98, at 50; *see* William B. Chandler III & Leo E. Strine, Jr., *The New Federalism of the American Corporate Governance System: Preliminary Reflections of Two Residents of One Small State*, 152 U. PA. L. REV. 953, 979 (2003).
[112] Griffith, *supra* note 98, at 50.

agreement; (2) they informed the hiring decision and the terms to two members of the compensation committee by phone; (3) the compensation committee approved the deal in its one-hour meeting, during which the committee also considered other agendas; and (4) the board then voted to approve the deal during its board meeting, which was led by Eisner. Certainly for a multi-billion dollar company like Disney, the board may not need to spend a considerable amount of time to deliberate a compensation package worth hundreds of millions of dollars. The Disney board probably had to discuss a number of important business agendas on a regular basis, so for Ovitz's hiring, the Disney board did not feel that it had to spend more time than what it actually spent. But suppose the Disney board disposed virtually all of its important business decisions in the same fashion as how it approved Ovitz's employment agreement. Then the board is more likely to have "consciously disregarded" its responsibilities. If a board simply disposes its duties by following the executives' directions, then the board is more like a façade, without performing any useful functions, let alone performing any monitoring role.

To be sure, Chancellor Chandler was sensitive to Eisner's dominance in the board. When discussing the good faith doctrine, Chancellor Chandler mentions the "imperial CEO," implying Eisner's control over the board. But if the court only focuses on facts surrounding Ovitz's hiring decision, then no matter how dominant Eisner was in this one transaction, the court may not be certain that this dominance rises to the level of an "imperial CEO." The court may also be particularly sensitive to its hindsight bias, unable to conclude that the board was virtually useless based on only the facts surrounding this one transaction. If the court sees a consistent pattern of Eisner guiding the board in virtually all matters, then the plaintiffs have a much stronger claim that the board was not in good faith and failed its fiduciary duty.

IV. Conclusion

Boards of directors in the real world possess a number of characteristics contrary to what the law assumes. Because of these characteristics, boards of directors have performed their monitoring job unsatisfactorily to most shareholders and to the public. First, shareholders do not choose most directors; instead, shareholders elect the directors because firms' executives have nominated the directors on the election ballot. As a result, directors naturally are more loyal to the executives than to the shareholders. Second, within the board, directors face the same collective action problems as faced by shareholders. The directors are of equal status on the board, so each member shares a small portion of the benefit from monitoring but has to bear the full cost. The directors have a poor incentive to be active because their compensation usually does not award them to spend extra effort than to merely attend board meetings. The boards' large size for most publicly traded companies further aggravates the collective action problem. Third, executives have a natural tendency to entrench the board. This tendency drives the board members to gradually defer to the executives.

Independent directors still face the same problems as insider directors, and in many situations, the problems are even worse with independent directors. The independent directors are still chosen by a firm's executives, their livelihood is less attached to the firm's success, and they must spend more effort than insider directors to learn about the firm. Except perhaps during crisis, independent directors are not better than insider directors in their monitoring role. This explains why studies have consistently concluded that independent directors do not improve a firm's performance and these directors have a positive influence on the firm at best during crisis. Disney, Worldcom, and Enron are three recent examples of massive boards' monitoring failure, even though in all three cases, the boards were composed of a majority of independent directors.

Despite these studies' consistent findings that independent directors do not perform a better monitoring role, Congress enacted the Sarbanes-Oxley Act, under which all publicly traded corporations must have audit committees composed entirely of independent directors. But even though SOX is a poor means to an end, it is Congress's response to public outcries over a series of corporate scandals. This response also reflects how state law has unsatisfactorily shaped corporate governance. Therefore, states, particularly Delaware, should step up and reassess its basic legal assumptions towards boards' role. I propose that the Delaware courts adopt an expansive good faith evaluation for overall board operations instead of focusing solely on the transaction in dispute. Without looking beyond one board transaction, the court may not have sufficient facts to conclude that the board has in general failed its monitoring role. This expansive good faith evaluation should not deter directors' risk taking or deter qualified individuals from serving on corporate boards. Moreover, this expansive good faith evaluation is more like a character valuation, for which judges are well suited and often called upon to perform. This expansive good faith evaluation may add pressures to corporate boards to evaluate their own monitoring role on a regular basis and may thus push them to become more active.

A magic formula to cure boards' monitoring deficiencies probably does not exist. But a uniform federal statute making rigid requirements on all public traded corporations creates only inefficiencies without leading to any of the intended consequences. These inefficiencies will eventually be borne by shareholders and the overall economy. Time is set for state law to make a drastic change.