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Confusion and Upredictability in Shareholder Derivative Litigation: The Delaware Courts' Response to Recent Corporate Scandals

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CONFUSION AND UNPREDICTABILITY IN SHAREHOLDER DERIVATIVE LITIGATION: THE DELAWARE COURTS' RESPONSE TO RECENT CORPORATE SCANDALS

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Abstract

The Delaware courts responded to the recent wave of corporate scandals, exemplified by Enron and WorldCom, by changing their approach to shareholder derivative litigation. This Article analyzes the Delaware courts' response to these scandals and concludes that the courts have created doctrinal confusion and introduced unpredictability into derivative litigation. This Article also analyzes the future negative consequences for shareholders, corporations, directors, investors, and other litigants. Finally, this Article proposes improvements for derivative litigation that may alleviate the confusion and unpredictability created by the Delaware courts' response to the recent scandals.

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I. INTRODUCTION

Corporate law has radically changed in response to the wave of corporate scandals that began in 2001.[1] The highly publicized scandals at Enron, WorldCom, and other corporations revealed officers who were out of control and directors who were asleep at the wheel.[2] Congress responded by enacting the Sarbanes–Oxley Act of 2002,[3] which imposes new requirements on the officers and directors of publicly traded corporations,[4] and forces listing companies—such as the New York Stock Exchange (NYSE) and NASDAQ—to impose more restrictive requirements on public companies.[5] The Securities and Exchange Commission (SEC) also adopted numerous new regulations in response to the scandals.[6] Undoubtedly, Sarbanes–Oxley "shook up America's boardrooms and forced corporate executives to rethink the way they had been doing things."[7] Statutory and regulatory requirements, however, do not represent the only changes facing corporations. The courts are

1. *See* E. Norman Veasey, *State–Federal Tension in Corporate Governance and the Professional Responsibilities of Advisors*, 28 J. CORP. L. 441, 441–42 (2003) (stating that "the Enron debacle erupted" in the fall of 2001, "[s]oon thereafter Worldcom crashed," and "[o]ther corporate disasters were to follow in quick succession").

2. *See id.* (noting that the Enron and WorldCom scandals revealed that "(1) officers ran amok, wallowing in greed-driven schemes and other abuses; and (2) directors allowed it to happen, tolerating officers who were managing to the market while they contented the directors with ever-rising stock prices").

3. Pub. L. No. 107-204, 116 Stat. 745 (codified as amended in scattered sections of 15 U.S.C. and 18 U.S.C.).

4. *See* Sarbanes–Oxley Act of 2002, § 302, 15 U.S.C. § 7241 (Supp. IV 2004).

5. *See* Sarbanes–Oxley Act of 2002, § 301, 15 U.S.C. § 78j-1(m).

6. For a summary and explanation of the new SEC regulations, see David Martin, *Compliance Obligations Under Sarbanes–Oxley Act and Related SEC Regulations*, BANKING & FIN. SERVICES POL'Y REP., June 2005, at 6. For a summary of the rules that apply to attorneys, see Charles E. McCallum, *The SEC Standards of Professional Conduct for Attorneys Under the Sarbanes–Oxley Act*, DEL. LAW., Spring 2003, at 10.

7. DAVID SKEEL, ICARUS IN THE BOARDROOM: THE FUNDAMENTAL FLAWS IN CORPORATE AMERICA AND WHERE THEY CAME FROM 182 (2005).

changing as well.[8] The Delaware courts, which lead the development of corporate common law,[9] also responded to the recent corporate scandals, but unfortunately, this judicial response injected doctrinal confusion and unpredictability into shareholder derivative litigation.

Corporate scholars have long debated the merit of shareholder derivative litigation as a method of influencing corporate governance.[10] Yet, despite this debate, shareholder derivative litigation continues to serve as a primary method by which shareholders hold directors accountable for their actions. Nothing in Sarbanes–Oxley altered shareholders' ability to file derivative litigation, and scholars have not proposed modifying such litigation in response to the recent scandals.

Corporate scholars have analyzed the causes of the recent scandals and the scandals' impact on corporate governance.[11] They have critiqued Sarbanes–Oxley[12] and the SEC's new regulations that implement Sarbanes–Oxley.[13] Corporate scholars have even evaluated

8. *See, e.g.*, Lisa M. Fairfax, *Spare the Rod, Spoil the Director? Revitalizing Directors' Fiduciary Duty Through Legal Liability*, 42 HOUS. L. REV. 393, 416–17 (2005). The Sarbanes–Oxley Act did not displace the common-law fiduciary duties or the business judgment rule, particularly because "it fails to impose any direct legal penalties on directors who breach" the Act. *See id.* at 395, 405–07.

9. *See* William H. Rehnquist, Chief Justice of the United States, Remarks Given on the Occasion of the Bicentennial Celebration of the Delaware Court of Chancery: Prominence of the Delaware Court of Chancery in the State–Federal Joint Venture of Providing Justice (Sept. 18, 1992), *in* 48 BUS. LAW. 351, 354 (1992) (describing Delaware's preeminence in corporate law); *see also* Veasey, *supra* note 1, at 443 ("Delaware law is the default repository for the rich and comprehensive common law of fiduciary duty of directors . . . .").

10. *See, e.g.*, Daniel R. Fischel & Michael Bradley, *The Role of Liability Rules and the Derivative Suit in Corporate Law: A Theoretical and Empirical Analysis*, 71 CORNELL L. REV. 261, 279 (1986); Roberta Romano, *The Shareholder Suit: Litigation Without Foundation?*, 7 J.L. ECON. & ORG. 55, 55–56 (1991).

11. *See generally* JOHN C. COFFEE JR., GATEKEEPERS: THE PROFESSIONS AND CORPORATE GOVERNANCE (2006) (discussing the corporate scandals and their impact on corporate governance); TAMAR FRANKEL, TRUST AND HONESTY: AMERICA'S BUSINESS CULTURE AT A CROSSROAD (2006) (same); SKEEL, *supra* note 7 (same).

12. *See, e.g.*, Larry E. Ribstein, *Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes–Oxley Act of 2002*, 28 J. CORP. L. 1, 18–47 (2002); Roberta Romano, *The Sarbanes–Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521 (2005); *see also* Geraldine Szott Moohr, *An Enron Lesson: The Modest Role of Criminal Law in Preventing Corporate Crime*, 55 FLA. L. REV. 937, 952–56 (2003) (explaining that the severe criminal penalties in Sarbanes–Oxley are unlikely to deter future conduct); *cf.* Jonathan R. Macey, *A Pox on Both Your Houses: Enron, Sarbanes–Oxley and the Debate Concerning the Relative Efficacy of Mandatory Versus Enabling Rules*, 81 WASH U. L.Q. 329, 349–55 (2003) (noting the shortcomings of the Act but acknowledging that "Sarbanes–Oxley was a measured and appropriate response to the abject failures in U.S. corporate governance").

13. *See, e.g.*, Irwin H. Steinhorn & William M. Lewis, *Corporate Compliance Under the Regulations Implementing Sarbanes–Oxley*, 60 CONSUMER FIN. L.Q. REP. 30 (2006); Miriam Miquelon Weismann, *Corporate Transparency or Congressional Window-Dressing? The Case Against Sarbanes–Oxley as a Means to Avoid Another Corporate Debacle: The Failed Attempt to*

Sarbanes–Oxley's impact on fiduciary duties under state law.[14] These scholars, however, have not thoroughly examined the Delaware courts' response to the recent scandals. This Article will examine the Delaware courts' response and analyze its impact within the context of shareholder derivative litigation.

Since the recent wave of corporate scandals, the Delaware courts have applied new scrutiny to allow shareholder derivative actions to survive pretrial motions asserting the business judgment rule defense. The long history of *In re Walt Disney Co. Derivative Litigation* (*Disney*) exemplifies Delaware's "new" approach.[15] The *Disney* shareholders challenged the directors' decisions regarding the compensation paid to the company's former president.[16] The Delaware Chancery Court originally dismissed the case,[17] and the dismissal was consistent with courts' historical practice of deferring to the compensation decisions of a board of directors, a majority of which were disinterested in the transaction. The Delaware Chancery Court thus granted the pretrial motion to dismiss relying on the business judgment rule, which operates as a defense preventing shareholders from challenging directors' decisions unless the shareholders can overcome the presumption that the directors acted consistent with their fiduciary duties.[18] On appeal, the Delaware Supreme Court agreed that the case had been properly dismissed but gave the plaintiffs leave to replead a portion of their complaint.[19] In the aftermath of the recent scandals, the Delaware Chancery Court denied the *Disney* directors' motion to dismiss the amended complaint.[20] The *Disney* plaintiffs ultimately survived multiple pretrial motions, conducted discovery, and took the case to trial.[21]

Revive Meaningful Regulatory Oversight, 10 STAN. J.L. BUS. & FIN. 98 (2004).

14. *See, e.g.*, Fairfax, *supra* note 8, at 395–96, 405–07 (examining the failure of Sarbanes–Oxley to impose any direct legal penalties on directors); Lyman P.Q. Johnson & Mark A. Sides, *The Sarbanes–Oxley Act and Fiduciary Duties*, 30 WM. MITCHELL L. REV. 1149, 1209–19 (2004) (examining the interplay between Sarbanes–Oxley and fiduciary duties under state law).

15. Brehm v. Eisner (*In re* Walt Disney Co. Derivative Litig.) (*Disney VI*), 906 A.2d 27 (Del. 2006). For simplicity's sake, this Article uses "*Disney*" to refer generally to the entire derivative litigation.

16. *Id.* at 35.

17. *Id*. at 35 n.1; *In re* Walt Disney Co. Derivative Litig. (*Disney I*), 731 A.2d 342, 380 (Del. Ch. 1998), *aff'd in part, rev'd in part sub nom.* Brehm v. Eisner (*Disney II*), 746 A.2d 244 (Del. 2000).

18. *See infra* Part II.B; *see also* Simon A. Rodell, Note, *Plumbing in the Boardroom: Plugging Boardroom Leaks Through a Good Faith Duty of Confidentiality*, 59 FLA. L. REV. 631, 635, 638 n.37 (2007).

19. *Disney II*, 746 A.2d at 266.

20. *In re* Walt Disney Co. Derivative Litig. (*Disney III*), 825 A.2d 275, 290–91 (Del. Ch. 2003).

21. *In re* Walt Disney Co. Derivative Litig. (*Disney V*), 907 A.2d 693, 697 (Del. Ch. 2005),

The Delaware courts' motivations for applying new scrutiny to directors' decisions are obvious: First, they wanted to remedy the corporate governance failures observed in the recent scandals. Second, they wanted to stop federal regulation from supplanting state law's ability to govern corporations' internal affairs. However, the Delaware courts' changes are not obvious. Unlike the new requirements imposed by Sarbanes–Oxley, the SEC, and the listing companies, the Delaware courts have not defined any new requirements.

Recent Delaware opinions allow more cases to survive pretrial motions asserting the business judgment rule defense, yet the opinions fail to identify new liability standards. Instead, the Delaware courts have relied on their prior broad descriptions of directors' fiduciary duties and on an evolving notion of "best practices." Unfortunately, at the same time, the courts have ignored the much lower standards of liability historically applied when analyzing whether directors breached their fiduciary duties to determine whether directors should receive the protection of the business judgment rule. As a result, the Delaware courts have effectively raised the requirements for dismissal based on the business judgment rule and have given less deference to directors' decisions. Thus, by failing to define coherent standards for analyzing the business judgment rule while allowing more cases to survive pretrial motions, the Delaware courts have created doctrinal confusion and introduced unpredictability into derivative litigation.

The uncertainty created by Delaware common law potentially harms corporations, directors, shareholders, the investing public, and other litigants. It leaves Delaware corporations and their directors bereft of guidance on how to conduct themselves to receive protection from the business judgment rule, and particularly how to receive such protection at the earliest stages of future litigation. This uncertainty also impacts directors' decision-making authority and may lead directors to become more risk averse. If directors fear taking reasonable business risks to increase shareholder wealth, shareholders may be harmed. Shareholders may also be harmed by a derivative action because all shareholders of a corporation ultimately bear the litigation expenses, which could easily outweigh the beneficial recovery, if any, for the corporation. In addition, attorneys who file shareholder derivative lawsuits cannot accurately evaluate the merits, the likelihood of success, or the settlement value of potential lawsuits. Further, other state courts, which look to Delaware on matters of corporate law,[22] lack guidance in evaluating assertions of the

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aff'd, 906 A.2d 27 (Del. 2006). Although the Delaware Supreme Court ultimately affirmed the finding that Disney's board of directors did not breach their fiduciary duties, *Disney VI*, 906 A.2d at 35–36, the case's progression to trial illustrates the Delaware courts' new trend.

22. *See* Mullen v. Acad. Life Ins. Co., 705 F.2d 971, 973 n.3 (8th Cir. 1983) ("[C]ourts of other states commonly look to Delaware law . . . for aid in fashioning rules of corporate law.");

business judgment rule for the entities incorporated in their states.[23] If more derivative actions survive pretrial motions, other litigants will also be harmed because their cases will be delayed while the courts handle lengthy derivative actions. Finally, potential investors may not invest in stocks if derivative litigation causes the investors to lose confidence in director-managed corporations. The only winners from the confusion and uncertainty created by the Delaware courts are attorneys, who may bill huge fees while litigating such cases.

Completely abolishing derivative actions, however, would also harm corporations and shareholders. Shareholder derivative litigation provides one of the few tools that shareholders can use to hold directors accountable for their decisions. The threat of derivative litigation also potentially deters directors from making decisions that are not in the best interests of the corporation and its shareholders. This deterrence function may enhance corporate governance. At the same time, improvements are necessary to remove the doctrinal chaos and unpredictability that the Delaware courts have unnecessarily introduced into derivative litigation in response to recent scandals.

Improvements could include enacting a statute to define the standards for the business judgment rule and for alleged breaches of the fiduciary duties. The business judgment rule supplies the pivotal defense for corporations and directors in derivative litigation, and the defendant-directors may assert the defense both in pretrial motions and at trial. If a plaintiff cannot overcome the defense, the case ends. If the business judgment rule continues to set the standard by which courts measure directors' actions in derivative litigation, then that standard must be coherently and predictably applied by courts and potential litigants. The standard must also provide proper deference to directors to protect corporations and the majority of shareholders from those few shareholders who want to second-guess, with the aid of hindsight, board decisions that turned out poorly. Similarly, the standard must protect corporations and shareholders from the few shareholders pursuing only personal interests and from the plaintiffs' attorneys seeking only the attorneys' fees produced by derivative litigation. Thus, the business judgment rule must afford a plaintiff the opportunity to rebut the defense's presumption in egregious cases but must also set an appropriately high hurdle to prevent frivolous and meritless litigation.

Andrew D. Arons, *In Defense of Defensive Devices: How Delaware Discouraged Preventive Measures in* Omnicare v. NCS Healthcare, 3 DEPAUL BUS. & COM. L.J. 105, 130 (2004) ("[M]ost states look towards Delaware's corporate law decisions for guidance in their own holdings . . . .").

23. *See* Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 479 (1977) (noting that the law of the state of incorporation "'govern[s] the internal affairs of the corporation'" (quoting Cort v. Ash, 422 U.S. 66, 84 (1975), *abrogated on other grounds by* Touche Ross & Co. v. Redington, 442 U.S. 560 (1979))).

Additionally, new requirements could be imposed to deter plaintiffs from filing frivolous actions. The recent amendment of Delaware Chancery Court Rule 23.1[24] attempts to deter such cases, but the rule does not go far enough. New procedural devices should also be implemented to assess the business judgment rule early in litigation to terminate meritless actions before the parties spend significant amounts of time and money.

Part II of this Article discusses the hurdles of shareholder derivative litigation as well as the traditional formulations and justifications of the business judgment rule. In Part III, this Article demonstrates the Delaware courts' recent willingness to allow shareholder derivative actions to survive pretrial motions asserting the business judgment rule. Part IV explains that, despite the apparent change in the assessment of the business judgment rule when asserted in pretrial motions, the Delaware courts have not changed the substantive law governing derivative litigation. Rather the courts now rely on prior cases' broad descriptions of "best practices" and the standards of conduct for directors' fiduciary duties, and not prior cases' lower standards of liability for evaluating alleged breaches of those fiduciary duties. Finally, Part V analyzes the potential negative consequences from the doctrinal confusion and unpredictability that the Delaware courts have injected into shareholder derivative litigation; Part V then proposes several improvements to shareholder derivative litigation.

II. The Hurdles of Shareholder Derivative Litigation

Currently, disgruntled shareholders wanting to bring a derivative action[25] may face several procedural hurdles.[26] The two most significant procedural hurdles that shareholder-plaintiffs face are motions to dismiss based on (1) the demand requirement or (2) the recommendation of a special litigation committee. The business judgment rule defense lies at the heart of both motions, and defendants can raise this defense in a motion to dismiss for failure to state a claim, a motion for summary judgment, or at trial.[27]

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24. *See* DEL. CH. CT. R. 23.1.

25. A shareholder may file a derivative action on behalf of a corporation to enforce a cause of action belonging to the corporation on account of an injury to the corporation. STEPHEN M. BAINBRIDGE, CORPORATION LAW AND ECONOMICS § 8.2, at 362 (2002). A shareholder may file a direct action if the cause of action belongs to the shareholder individually, for example in claims involving oppression of minority shareholders. *Id.* § 8.2, at 362–63. This Article explicitly discusses only derivative actions, although portions apply to direct actions as well.

26. *See* Fairfax, *supra* note 8, at 408 ("[T]he procedural rules related to shareholder suits for fiduciary duty breaches make it difficult for shareholders to even bring an action challenging director conduct . . . ."); Mark J. Loewenstein, *The Quiet Transformation of Corporate Law*, 57 SMU L. REV. 353, 362 (2004) ("[D]erivative actions are fraught with difficulties.").

27. Perhaps the most important hurdle for the potential shareholder-plaintiff is finding an attorney willing to bring a shareholder derivative action. Under Delaware law, however, this may not be much of a hurdle for the reasons discussed in Part V, *infra*.

A. *The Demand Requirement and the Special Litigation Committee*

The demand requirement provides the first procedural hurdle for a shareholder-plaintiff. By statute, corporate directors possess the authority to manage the corporation; thus, directors have authority to decide whether to pursue a lawsuit on behalf of the corporation.[28] Most states require a shareholder to make a demand on the board of directors before bringing a derivative action on behalf of the corporation.[29] Similarly, shareholder-plaintiffs may not sue in federal court unless they first make a demand on the board of directors.[30] A demand simply requests that the board rectify the challenged decision.[31] Thus, a shareholder typically must exhaust all available means to obtain relief through the corporation before filing a lawsuit on behalf of the corporation.

Upon receiving a shareholder demand, a board of directors can take one of three courses of action: (1) accept the demand and prosecute the claim itself, (2) resolve the matter internally, or (3) reject the demand.[32] Anecdotal evidence strongly suggests that boards typically reject the demand.[33] If the board rejects the demand, the shareholder may seek judicial review but must prove that the board rejected the demand wrongfully.[34] The business judgment rule defense provides the relevant standard for reviewing the board's rejection.[35]

Courts will excuse the demand requirement, however, if the demand would be futile.[36] A court may excuse demand as futile if a majority of the directors either allegedly participated in the challenged decision or are otherwise interested in the challenged transaction.[37] In other words, excusal from demand requires the plaintiff to show that the business

28. *See, e.g.*, DEL. CODE ANN. tit. 8, § 141(a) (2008) ("The business and affairs of every corporation . . . shall be managed by or under the direction of a board of directors . . . ."); MODEL BUS. CORP. ACT § 8.01(b) (2007) ("All corporate powers shall be exercised by or under the authority of the board of directors of the corporation, and the business and affairs of the corporation shall be managed by or under the direction, and subject to the oversight, of its board of directors, subject to any limitation set forth in the articles of incorporation . . . .").

29. *See, e.g.*, DEL. CH. CT. R. 23.1.

30. FED. R. CIV. P. 23.1.

31. *See, e.g.*, *id*.

32. *See* Fairfax, *supra* note 8, at 408.

33. *Id.* (noting that most boards "decide not to bring any action").

34. BAINBRIDGE, *supra* note 25, § 8.5, at 395; *see also* Fairfax, *supra* note 8, at 408 ("[A]lthough shareholders can challenge [directors' rejection of a demand request], most courts defer to boards on this matter.").

35. BAINBRIDGE, *supra* note 25, § 8.5, at 395.

36. Aronson v. Lewis, 473 A.2d 805, 814–15 (Del. 1984), *overruled on other grounds by* Brehm v. Eisner (*Disney II*), 746 A.2d 244 (Del. 2000).

37. *Id.*

judgment rule does not apply to the board's decision.[38] Consequently, if a shareholder files suit without making a demand on the board, the shareholder must show that demand should be excused as futile by pleading particular facts sufficient to rebut the presumption of the business judgment rule.[39] Although plaintiffs may argue that they confront difficulties alleging such facts with particularity in advance of taking discovery, such arguments typically fail.[40] Courts state that plaintiffs already possess the tools for gathering sufficient evidence through the shareholders' right to inspect the corporation's books, which include the minutes of meetings of the board of directors.[41]

Director-defendants will typically file a motion to dismiss on the demand requirement soon after a derivative action begins.[42] In cases where the plaintiff made a demand that the board rejected, the issue is whether that rejection was wrongful. In cases where the plaintiff failed to make a demand, the issue is whether demand should be excused. In these latter cases, if the shareholder wins and demand is excused, the lawsuit continues. If the shareholder loses, however, then the shareholder must make a demand on the board.[43] Assuming the board rejects the demand, the shareholder-plaintiff must prove that the board wrongly rejected the demand.[44] The shareholder then is in the same position as if the shareholder, before filing suit, had made a demand that the board rejected. Thus, most shareholders forgo making a demand on the board of directors and file their shareholder derivative actions hoping that the court will excuse demand.[45]

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38. Beneville v. York, 769 A.2d 80, 85 n.9 (Del. Ch. 2000).

39. *Id.*; FED. R. CIV. P. 23.1.

40. *Cf.* Stephen M. Bainbridge, *The Business Judgment Rule as Abstention Doctrine*, 57 VAND. L. REV. 83, 97 n.85 (2004) ("Note that mere allegations of director impropriety do not entitle plaintiff to discovery. Accordingly, business judgment rule claims should be determined as a motion to dismiss on the pleadings rather than at the summary judgment stage." (citation omitted)).

41. *See* Grimes v. Donald, 673 A.2d 1207, 1216 n.11 (Del. 1996) (describing shareholders' "tools at hand" to include public sources, such as the media and governmental agencies, and the right to inspect corporate records), *overruled on other grounds by Disney II*, 746 A.2d 244; Rales v. Blasband, 634 A.2d 927, 934–35 n.10 (Del. 1993) (same); *see also* DEL. CODE ANN. tit. 8, § 220(b) (2008) (providing for a shareholder's right to inspect corporate records); MODEL BUS. CORP. ACT § 16.02 (2007) (same).

42. Similarly, defendants may raise a motion to dismiss for failure to state a claim. McMullin v. Beran, 765 A.2d 910, 918 (Del. 2000) (holding that the business judgment rule protects directors "unless effectively pled factual allegations in the . . . [c]omplaint successfully rebut the procedural presumption of the business judgment rule").

43. BAINBRIDGE, *supra* note 25, § 8.5, at 393–94.

44. *Id.* § 8.5, at 395.

45. *Id.* § 8.5, at 393–94.

A second hurdle faces some shareholder-plaintiffs—the possibility that a special litigation committee (SLC), composed of independent and disinterested directors, will move to dismiss the action based on the SLC's recommendation that continuing the litigation would not be in the corporation's best interests.[46] One commentator has described the formation and nature of an SLC as follows:

> If a shareholder brought colorable claims against some of the directors, counsel would first instruct the board of directors to amend the corporation's bylaws, increasing the number of directors. Second, the board would appoint two or three "expansion" directors to the positions so created who could have had no possible connection to the alleged wrongdoing and who, in addition, often would be "purer than the driven snow." Third, the full board would delegate to the committee all the board's power to deal with the pending action or shareholder demand that an action be brought. Once convened, the SLC would then hire an independent law firm to conduct a factual investigation of the shareholder's allegations and to research the applicable law. The firm would report periodically to the SLC and involve SLC members in the investigation, at least at crucial stages. In the typical scenario, eight or ten months later the SLC will promulgate a report, which it files with the court. Appended to the report will be a voluminous report of the investigation and a legal memorandum. By motion for summary judgment, the SLC will then ask the court to dismiss the shareholder action as having been found by the SLC "not in the corporation's best interests."[47]

When an SLC recommends that continuing the lawsuit would not be in the best interests of the corporation and then moves to dismiss based upon that recommendation, most courts afford that recommendation business judgment rule protection.[48] Under this deferential review, courts rely on

46. Douglas M. Branson, W. Edward Sell Chair in Law, Univ. of Pittsburgh, The Indiana Supreme Court Lecture: The Rule That Isn't a Rule—The Business Judgment Rule (Sept. 20, 2001), *in* 36 VAL. U. L. REV. 631, 647–48 (2002). An SLC may have reason to believe that dismissing the lawsuit is in the corporation's best interest because dismissing a derivative action might increase stock price. *See* Fischel & Bradley, *supra* note 10, at 279.

47. Branson, *supra* note 46, at 648 (footnote omitted).

48. In New York and other states, the plaintiff bears the burden of rebutting the business judgment rule presumption with respect to the SLC's decision, and judicial inquiry is limited to the disinterestedness and independence of the SLC's members and the adequacy of their investigation. *See* Auerbach v. Bennett, 393 N.E.2d 994, 996, 1001 (N.Y. 1979); *see also* Finley v. Superior Court, 96 Cal. Rptr. 2d 128, 132 (Ct. App. 2000) (stating that a court should dismiss a derivative action upon an SLC's recommendation if the SLC members were independent and adequately

the SLC's recommendation and grant the motion "in the vast majority of cases."[49]

A motion to dismiss based on the demand requirement and a motion to dismiss based on an SLC recommendation both ultimately involve the business judgment rule. The business judgment rule thus arises as a hurdle for shareholders at the beginning of a lawsuit and at any point in litigation when an SLC moves to dismiss the lawsuit. Directors may also assert the business judgment rule in a motion to dismiss for failure to state a claim, a motion for summary judgment, or at trial. Therefore, a shareholder-plaintiff will inevitably encounter the business judgment rule.

B. *The Business Judgment Rule Defense*

At its most basic, the business judgment rule supplies a defense in shareholder derivative actions that challenge a decision by a corporation's board of directors.[50] Defendants currently may assert the business judgment rule on a motion to dismiss, a motion for summary judgment, or at trial.[51] The business judgment rule has existed in American corporate

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investigated the challenged decision); Cutshall v. Barker, 733 N.E.2d 973, 978 (Ind. Ct. App. 2000) (stating that to avoid dismissal, shareholder-plaintiffs have the burden of proving that the committee was not disinterested or did not conduct a good-faith investigation); Janssen v. Best & Flanagan, 662 N.W.2d 876, 884 (Minn. 2003) (extending business judgment deference to the committee's decision as long as the committee is disinterested and informs itself fully on the issues). Some states also give business judgment rule protection to an SLC recommendation but appear to place the burden of proof on the defendants. *See, e.g.*, Hasan v. CleveTrust Realty Investors, 729 F.2d 372, 378–79 (6th Cir. 1984) (stating that a court should dismiss a derivative action upon an SLC's recommendation if the defendants show that they reasonably investigated, were independent, and acted in good faith); Lewis v. Boyd, 838 S.W.2d 215, 224 (Tenn. Ct. App. 1992) (stating that a derivative action should be dismissed only after the court (1) finds that the committee was independent and (2) critically reviews the committee's findings to determine whether they are made in good faith, supported by the record of the investigation, and are consistent with the best interests of the corporation). In Delaware, by contrast, the defendant bears the burden of proving the independence and good faith of the SLC, and the court may inquire into the bases supporting the SLC's recommendation and may apply its own business judgment as to whether the case should be dismissed. Zapata Corp. v. Maldonado, 430 A.2d 779, 787–89 (Del. 1981).

49. Fairfax, *supra* note 8, at 409 (citing Carol B. Swanson, *Juggling Shareholder Rights and Strike Suits in Derivative Litigation: The ALI Drops the Ball*, 77 MINN. L. REV. 1339, 1356–58 (1993)).

50. Brehm v. Eisner (*In re* Walt Disney Co. Derivative Litig.) (*Disney VI*), 906 A.2d 27, 52 (Del. 2006).

51. *See In re* Walt Disney Co. Derivative Litig. (*Disney V*), 907 A.2d 693, 697 (Del. Ch. 2005) (holding, after a lengthy trial, that the defendants were entitled to business judgment rule protection), *aff'd*, 906 A.2d 27 (Del. 2006); *In re* BHC Commc'ns, Inc. S'holder Litig., 789 A.2d 1, 4 (Del. Ch. 2001) ("[I]t is a bedrock principle of Delaware corporate law that, where a claim for breach of fiduciary duty fails to contain allegations of fact that, if true, would rebut the presumption of the business judgment rule, that claim should ordinarily be dismissed under Rule 12(b)(6)."); Weinberger v. United Fin. Corp. of Calif., Civ. A. No. 5915 (1979), 1983 WL 20290, at *6 (Del.

common law since at least the mid-1800s[52] and is based largely on two general rationales. First, the business judgment rule provides the protection necessary for directors to carry out their responsibility to manage the corporation[53] without fear of shareholders second-guessing directors' decisions with the benefit of hindsight.[54] If directors feared derivative litigation from every board decision, then directors might not take calculated business risks.[55] Some commentators further suggest that individuals would not serve as directors without the protection of the business judgment rule.[56] Second, directors are "better-suited than courts to make business decisions."[57] Thus, the rule protects directors from

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Ch. Oct. 13, 1983) (noting that to defeat a summary judgment motion, a plaintiff can "allude to facts in the record which are undisputed or which are disputed but, if true, are sufficient to rebut the presumption" of the business judgment rule).

52. S. Samuel Arsht, *The Business Judgment Rule Revisited*, 8 HOFSTRA L. REV. 93, 93 (1979) (stating that the business judgment rule is "a common law principle of corporate governance that has been part of corporate law for at least 150 years"); *see* Branson, *supra* note 46, at 633 (stating that the business judgment rule "remains an exclusively American legal construct" with the exception of Australia, which enacted a version of the rule in 1999).

53. Omnicare, Inc. v. NCS Healthcare, Inc., 818 A.2d 914, 927 (Del. 2003) ("'The business judgment rule, as a standard of judicial review, is a common-law recognition of the statutory authority to manage a corporation that is vested in the board of directors.'" (quoting MM Cos. v. Liquid Audio, Inc., 813 A.2d 1118, 1127 (Del. 2003))); Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985) (stating that the business judgment rule "protect[s] and promote[s] the full and free exercise of the managerial power granted to Delaware directors").

54. *See* 1 A.L.I., PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 4.01 cmt. d (1994) (stating that the business judgment rule protects directors "from the risks inherent in hindsight reviews of their unsuccessful decisions" and avoids "stifling innovation and venturesome business activity"); Arsht, *supra* note 52, at 95 (stating that the business judgment rule recognizes that "as human beings, directors are not infallible" and "the need to foster both business and judicial economy by not allowing every corporate transaction to be subject to judicial review at the request of a disagreeing stockholder").

55. *See* Bainbridge, *supra* note 40, at 110 (stating that encouraging risk-taking justifies the business judgment rule); *see also* Branson, *supra* note 46, at 637 ("Once on the board, a strong business judgment rule is necessary to encourage those independent directors to engage in the type of informed risk taking that is essential to business success."); *id.* at 632 (stating that the business judgment rule is "built upon economic freedom and the encouragement of informed risk taking"); Len Costa, *Boss of the Bosses: Delaware's Most Important Judge Takes on Greedy Executives, Congress, and the History of Corporate Law*, LEGAL AFF., July/Aug. 2005, at 43, 46 ("More than most judicial institutions, the Delaware Chancery Court doesn't second-guess decisions made by informed, disinterested boards, for fear of chilling commerce and innovation.").

56. Arsht, *supra* note 52, at 97 ("The business judgment rule grew principally from the judicial concern that persons of reason, intellect, and integrity would not serve as directors if the law exacted from them a degree of prescience not possessed by people of ordinary knowledge."); R. Franklin Balotti & Mark J. Gentile, *Elimination or Limitation of Director Liability for Delaware Corporations*, 12 DEL. J. CORP. L. 5, 9 (1987) ("The general result has been that many qualified individuals have refused to serve as directors.").

57. Fairfax, *supra* note 8, at 410; *see* Dodge v. Ford Motor Co., 170 N.W. 668, 684 (Mich. 1919) ("The judges are not business experts."); Branson, *supra* note 46, at 637 (stating that "courts

liability "for honest mistakes of judgment or unpopular business decisions."[58] Despite expansive attention from courts, academics, and practitioners, the business judgment rule remains heavily debated[59]—the principal point of contention being how courts should apply the rule.[60]

As articulated by the Delaware courts, the business judgment rule creates a presumption that directors have acted in accordance with their fiduciary duties in making corporate decisions, and plaintiffs may rebut

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are ill-equipped to review business decisions" because the decisions "often involve intangibles, intuitive insights or surmises as to business matters such as competitive outlook, cost structure, and economic and industry trends" and are "not susceptible to systematic analysis"). This judicial deference for business decisions is difficult to justify because courts frequently review decisions of physicians, surgeons, psychiatrists, and engineers. *See* Bainbridge, *supra* note 40, at 120 (noting that "no 'medical judgment' or 'design judgment' rule precludes judicial review of malpractice or product liability cases"); *see also* FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 94 (1991) (asking why "the same judges who decide whether engineers have designed the compressors on jet engines properly . . . cannot decide whether a manager negligently failed to sack a subordinate who made improvident loans"); Hal R. Arkes & Cindy A. Schipani, *Medical Malpractice v. the Business Judgment Rule: Differences in Hindsight Bias*, 73 OR. L. REV. 587, 613–17 (1994) (discussing the differences between courts' review of business and medical decisions); Kenneth B. Davis, Jr., *Once More, the Business Judgment Rule*, 2000 WIS. L. REV. 573, 581 ("[J]udges should find it far easier to overcome the barrier of expertise and stand in the shoes of outside directors than in those of almost any of the other professionals whose actions courts are routinely called upon to review.").

58. Arsht, *supra* note 52, at 96; *see also* Bainbridge, *supra* note 40, at 113–14 ("Business decisions rarely involve black-and-white issues; instead, they typically involve prudential judgments among a number of plausible alternatives. Given the vagaries of business, moreover, even carefully made choices among such alternatives may turn out badly." (footnote omitted)).

59. *See* Bainbridge, *supra* note 40, at 83–84 ("Countless cases invoke it and countless scholars have analyzed it. Yet, despite all of the attention lavished on it, the business judgment rule remains poorly understood." (footnote omitted)); *see also* Davis, *supra* note 57, at 573 (noting that "thousands of pages of corporate law scholarship and commentary have been devoted to" the business judgment rule, "yet we remain short of any broad consensus" on its rationale); Henry G. Manne, *Our Two Corporation Systems: Law and Economics*, 53 VA. L. REV. 259, 270 (1967) (stating that the business judgment rule is "one of the least understood concepts in the entire corporate field").

60. Many commentators agree with the courts' formulation of the business judgment rule as a standard of liability or a standard of review, which operates as a burden-shifting scheme. *See, e.g.*, Arsht, *supra* note 52, at 133; Melvin Aron Eisenberg, *The Divergence of Standards of Conduct and Standards of Review in Corporate Law*, 62 FORDHAM L. REV. 437, 444–45 (1993). Other commentators believe that this view of the rule does nothing more than restate the principle that defendants are entitled to summary judgment when the plaintiff fails to make a prima facie case, and these commentators advocate that the rule instead should be viewed as an abstention doctrine. *See, e.g.*, Bainbridge, *supra* note 40, at 101; *id.* at 87 ("[T]he rule is better understood as a doctrine of abstention . . . ."); D.A. Jeremy Telman, *The Business Judgment Rule, Disclosure, and Executive Compensation*, 81 TUL. L. REV. 829, 830 (2007) (advocating that the business judgment rule "be aggressively conceived as a doctrine of abstention"). As *Disney* demonstrates, however, the Delaware courts are sticking with the burden-shifting scheme. Brehm v. Eisner (*In re* Walt Disney Co. Derivative Litig.) (*Disney VI*), 906 A.2d 27, 52 (Del. 2006) (quoting Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984), *overruled on other grounds by Disney VI*, 906 A.2d 27).

that presumption by showing fraud, illegality, waste, or breach of a fiduciary duty.[61] If the plaintiff fails to rebut the presumption, then the business judgment rule protects the directors and their decision.[62] However, if the plaintiff shows either that the director-defendants violated a fiduciary duty or that the business judgment rule does not apply because the defendants committed an act of fraud, illegality, or waste, then the presumption of the business judgment rule is rebutted.[63] Once the plaintiff rebuts the presumption, the directors must prove to the fact-finder that the challenged transaction was "entirely fair" to the corporation and its shareholders.[64]

Therefore, shareholder-plaintiffs have essentially two methods by which they may rebut an assertion of the business judgment rule. First, the plaintiff may show that the directors breached one or more of their fiduciary duties. Second, the plaintiff may show that the business judgment rule does not apply to the directors' actions because the actions were fraudulent, illegal, or wasteful.[65] In *Disney*, the Delaware Supreme Court endorsed this formulation of the business judgment rule. The court's analysis of the plaintiffs' waste allegation was separate from the analysis

61. *See Aronson*, 473 A.2d at 812; *see also* McMullin v. Beran, 765 A.2d 910, 916–17 (Del. 2000) ("Procedurally, the initial burden is on the shareholder plaintiff to rebut the presumption of the business judgment rule. To meet that burden, the shareholder plaintiff must effectively provide evidence that the defendant board of directors, in reaching its challenged decision, breached any *one* of its 'triad of fiduciary duties, loyalty, good faith or due care.' Substantively, 'if the shareholder plaintiff fails to meet that evidentiary burden, the business judgment rule attaches' and operates to protect the individual director-defendants from personal liability for making the board decision at issue." (footnotes omitted) (quoting Emerald Partners v. Berlin, 726 A.2d 1215, 1221 (Del. 1999) ("A breach of any one of the board of directors' triad of fiduciary duties, loyalty, good faith or due care, sufficiently rebuts the business judgment presumption and permits a challenge to the board's action under the entire fairness standard.") and Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 361 (Del. 1993))). *But see* R. Franklin Balotti & James J. Hanks, Jr., *Rejudging the Business Judgment Rule*, 48 BUS. LAW. 1337, 1345 (1993) (arguing that the business judgment rule does not provide a presumption "in the strict evidentiary sense of the term").

62. Citron v. Fairchild Camera & Instrument Corp., 569 A.2d 53, 64 (Del. 1989) (citing Smith v. Van Gorkom, 488 A.2d 858, 873 (Del. 1985)).

63. *Disney VI*, 906 A.2d at 52; *Emerald Partners*, 787 A.2d at 90–91; *Cede*, 634 A.2d at 361; *Aronson*, 473 A.2d at 812.

64. *Disney VI*, 906 A.2d at 52; *Emerald Partners*, 787 A.2d at 90–91; *Cede*, 634 A.2d at 361; *Aronson*, 473 A.2d at 812.

65. Paglin v. Saztec Int'l, Inc., 834 F. Supp. 1184, 1200 (W.D. Mo. 1993) ("[T]he business judgment rule does not apply when the act complained of is ultra vires, illegal, or fraudulent."); Shlensky v. Wrigley, 237 N.E.2d 776, 779 (Ill. App. Ct. 1968) ("'The directors are chosen to pass upon [questions of policy and business management,] and their judgment unless shown to be tainted with fraud is accepted as final.'" (emphasis omitted) (quoting Davis v. Louisville Gas & Elec. Co., 142 A. 654, 659 (Del. Ch. 1928))); Kamin v. Am. Express Co., 383 N.Y.S.2d 807, 811 (Sup. Ct. 1976) (noting that courts will not substitute their judgment for that of directors absent "fraud, dishonesty, or nonfeasance").

of whether the plaintiffs had rebutted the business judgment rule by showing a breach of fiduciary duty.[66] In analyzing the business judgment rule, the Delaware Supreme Court stated:

> Our 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." Those presumptions can be rebutted if the plaintiff shows that the directors breached their fiduciary duty of care or of loyalty or acted in bad faith. If that is shown, the burden then shifts to the director defendants to demonstrate that the challenged act or transaction was entirely fair to the corporation and its shareholders.[67]

Thus, the fiduciary duties imposed on directors supply the principal limitations on the business judgment rule.[68]

III. DELAWARE COURTS HAVE LOWERED THE HURDLES OF SHAREHOLDER DERIVATIVE LITIGATION

In the past, courts rarely rejected assertions of the business judgment rule.[69] However, some of that judicial deference has disappeared since the recent corporate scandals.[70] Nonetheless, the Delaware courts have not announced new liability standards or a new framework for analyzing the

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66. *Disney VI*, 906 A.2d at 73–74 ("This claim is rooted in the doctrine that a plaintiff who fails to rebut the business judgment rule presumptions is not entitled to any remedy unless the transaction constitutes waste.").

67. *Id.* at 52 (footnote omitted) (quoting *Aronson*, 473 A.2d at 812).

68. Arsht, *supra* note 52, at 96 ("[The business judgment rule's] significance lies also in the limitations to its availability as a defense to liability and the standard of directorial conduct those limitations establish. Far from constituting a shield from liability for fraud, mismanagement, or reckless decisions, the limitations on the business judgment rule's application impose significant duties on a director in the performance of his or her office." (footnote omitted)).

69. FRANKEL, *supra* note 11, at 183–84 ("There are some departures from the historical strong protection of corporate boards. For example, in the past two decades, the Delaware courts . . . were reluctant to make corporate directors liable for the wrongs committed by their corporations. The courts respected the directors' business judgment and, with a few notable exceptions, shielded the directors from the claims of shareholders."); Fairfax, *supra* note 8, at 409 ("[T]he tremendous deference courts grant to board decisions means that courts hold directors liable for only the most egregious examples of director misconduct.").

70. *See* FRANKEL, *supra* note 11, at 158 ("[T]he Delaware Court has begun to show far less deference to corporate management."); *see also* Costa, *supra* note 55, at 46 ("The parade of recent corporate scandals has further strained the notion that directors always know best. The Chancery Court has taken notice: Questionable behavior that might once have been dismissed under the business judgment rule is attracting a critical eye.").

business judgment rule. Nor have the Delaware courts stated new liability standards for alleged breaches of the fiduciary duties of care or loyalty. Yet, judicial enforcement of these standards has shifted.[71]

The Chief Justice of the Delaware Supreme Court has acknowledged that Delaware courts are applying "new scrutiny," yet the "'same law,'" to defendants in derivative actions.[72] He also stated that the Delaware courts' "'expectations of directors are evolving'" in light of recent corporate governance developments.[73] Recent cases demonstrate that the Delaware courts have given less deference to directors' decisions and have raised the requirements for directors to prevail on the business judgment rule in pretrial motions to dismiss, motions for summary judgment, and motions for preliminary injunctions.[74]

In *Disney*, the shareholder-plaintiffs alleged that the director-defendants breached their fiduciary duties in dealing with the company's former president, Michael Ovitz, a long-time friend of Disney's CEO and chairman, Michael Eisner.[75] Specifically, the directors allegedly breached their duties by approving Ovitz's hiring and later his severance payment.[76] After only fourteen months with Disney, Ovitz received a $140 million termination payment.[77] According to the plaintiffs, the directors approved the payment based only upon a summary of terms and conditions of the employment agreement and a brief discussion during two board meetings.[78] Thus, the directors' approval allegedly breached their fiduciary

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71. FRANKEL, *supra* note 11, at 184 ("In the past few years, the Delaware courts have shown that they can change their attitude in response to abuses. Of the five large shareholders' suits brought since 2002, all five were allowed to proceed. The tone of the courts has changed." (footnote omitted)); *see* Fairfax, *supra* note 8, at 418 ("Former Delaware Chancery Court judge William Allen confirmed the impact that Enron and Sarbanes–Oxley had on Delaware courts' willingness to increase directors' liability in order to ensure greater adherence to directors' fiduciary responsibilities." (citing Marc Gunther, Ovitz v. Eisner*: Boards Beware!*, FORTUNE, Nov. 10, 2003, at 171, 176)).

72. *See* John Gibeaut, *Stock Responses: Shareholders Ask for Changes in Corporate Governance, and the Courts Are Starting to See It Their Way*, A.B.A. J., Sept. 2003, at 38, 40 (quoting the Chief Justice of the Delaware Supreme Court).

73. *Id*. (quoting the Chief Justice of the Delaware Supreme Court).

74. *See* Renee M. Jones, *Rethinking Corporate Federalism in the Era of Corporate Reform*, 29 J. CORP. L. 625, 625 (2004); *id.* at 640–63 (discussing Sarbanes–Oxley, corporate scandals, and the judicial response in Delaware state courts); *see also* Ed Aro et al., Commentary, *Back to the Future: Coping with Post-Enron Attitude Changes of Judges and Juries*, ANDREWS CORP. OFFICERS & DIRECTORS LIABILITY LITIG. REP., Jan. 13, 2004, at 17 (discussing judges' willingness after Sarbanes–Oxley and recent corporate scandals to regulate corporate conduct once thought to have been beyond judicial scrutiny).

75. *In re* Walt Disney Co. Derivative Litig. (*Disney III*), 825 A.2d 275, 277–78 (Del. Ch. 2003) (stating the amended complaint's allegations).

76. *See id*.

77. *Id*. at 279.

78. *Id.*

duties because the directors did not (1) ask any questions about the payment, (2) review any documents, (3) consult experts, or (4) consider whether Ovitz should receive a severance payment for a "non-fault termination."[79]

When the *Disney* defendants moved to dismiss the original complaint, the Delaware Chancery Court granted the motion, stating that "courts [do not] overrule a board's decision to approve and later honor a severance package, merely because of its size."[80] On appeal, the Delaware Supreme Court agreed that the Delaware Chancery Court had properly dismissed the case but gave the plaintiffs leave to replead portions of their complaint.[81]

The *Disney* shareholder-plaintiffs subsequently amended their complaint to allege breaches of the duties of care and good faith for the same conduct, and the directors responded by again moving to dismiss the action based on the business judgment rule.[82] This second motion to dismiss occurred in the aftermath of Enron and WorldCom, and the Delaware Chancery Court denied the motion.[83] The court concluded that "the new complaint . . . gives rise to a reason to doubt whether the board's actions were taken honestly and in good faith" and that "the facts belie any assertion that the [directors] exercised any business judgment or made any good faith attempt to fulfill the fiduciary duties they owed to Disney and its shareholders."[84]

Delaware's change in evaluating the business judgment rule on pretrial motions can be seen in the court's statement that "[t]hese facts, if true . . . suggest that the defendant directors consciously and intentionally disregarded their responsibilities, adopting a 'we don't care about the risks' attitude concerning a material corporate decision."[85] The Delaware Chancery Court further noted that the alleged facts "impl[ied] that the defendant directors knew that they were making material decisions without adequate information and without adequate deliberation, and that they simply did not care if the decisions caused the corporation and its stockholders to suffer injury or loss."[86] Because the alleged facts gave "a reason to doubt business judgment protection," the Delaware Chancery Court denied the motion to dismiss.[87]

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79. *Id.* at 287–89. The shareholder-plaintiffs alleged that Ovitz should have been terminated for cause and thus that Ovitz should not have received the severance payment available only for a without-cause termination. *See id.*

80. *In re* Walt Disney Co. Derivative Litig. (*Disney I*), 731 A.2d 342, 350 (Del. Ch. 1998) (emphasis omitted), *aff'd in part, rev'd in part sub nom.* Brehm v. Eisner (*Disney II*), 746 A.2d 244 (Del. 2000).

81. *Disney II*, 746 A.2d at 267.

82. *Disney III*, 825 A.2d at 278.

83. *Id.*

84. *Id.* at 286–87 (emphasis omitted).

85. *Id.* at 289 (emphasis omitted).

86. *Id.* (emphasis omitted).

87. *Id.*

Having survived multiple pretrial motions, the *Disney* plaintiffs completed discovery and took their case to trial years later.[88] In the end, however, the plaintiffs' fate was no different than it would have been before the recent corporate scandals. After a four-month trial, the Delaware Chancery Court determined that, although Disney's directors did not comply with "best practices of ideal corporate governance," they "did not breach their fiduciary duties or commit waste."[89] The Delaware Supreme Court affirmed on appeal.[90] Despite the *Disney* plaintiffs' ultimate loss, they were able to pursue their claims much further than they would have in the past.

The *Disney* litigation and other recent cases illustrate the new trend in Delaware courts. For example, the Delaware Supreme Court reversed a grant of summary judgment on a duty-of-loyalty claim in *Telxon Corp. v. Meyerson*,[91] finding reasonable doubt existed about the directors' disinterestedness and independence.[92] Telxon had bought all the stock of a technology company owned by Telxon's chairman of the board, Meyerson, to induce him to serve as Telxon's CEO.[93] Shareholders filed a derivative action challenging the board's decision on grounds that the directors breached their duties of care and loyalty.[94] The shareholders alleged that Meyerson controlled the Telxon board.[95] Meyerson and the other director-defendants moved for summary judgment, arguing that the business judgment rule foreclosed the derivative action because a majority of the disinterested directors approved the transaction.[96] The Delaware Chancery Court granted the defendants' motion for summary judgment on all claims except for the duty-of-care claim.[97] On appeal, the Delaware Supreme Court reversed, finding that material issues of fact existed about whether Meyerson dominated or controlled Telxon's board:

88. After discovery, Michael Ovitz moved for summary judgment, which the Delaware Chancery Court granted in part and denied in part. *In re* Walt Disney Co. Derivative Litig. (*Disney IV*), No. Civ. A. 15452, 2004 WL 2050138, at *8 (Del. Ch. Sept. 10, 2004). The trial occurred between October 2004 and January 2005. *In re* Walt Disney Co. Derivative Litig. (*Disney V*), 907 A.2d 693, 697 (Del. Ch. 2005), *aff'd*, 906 A.2d 27 (Del. 2006).

89. *Disney V*, 907 A.2d at 697; *id.* at 763 (noting that conduct that falls "short of what shareholders expect and demand from those entrusted with a fiduciary position" and conduct that "does not comport with how fiduciaries of Delaware corporations are expected to act" cannot be sanctioned because such conduct is "not in violation of law").

90. Brehm v. Eisner (*In re* Walt Disney Co. Derivative Litig.) (*Disney VI*), 906 A.2d 27, 75 (Del. 2006); *id.* at 56 (comparing what happened in *Disney* "to what would have occurred had the committee followed a 'best practices' (or 'best case') scenario").

91. 802 A.2d 257 (Del. 2002).

92. *Id.* at 266.

93. *Id.* at 261.

94. *Id.* at 259.

95. *Id*. at 264.

96. *Id*. at 259.

97. *Id.*

> Telxon argues a majority of the other Directors were beholden to Meyerson, as Telxon's executive Chairman of the Board and "most senior executive," because he was in a position to affect their livelihood. Meyerson did play an integral role in Telxon's management for many years, both during and after his stint as CEO, and it is clear that the other Directors respected his business acumen and often relied upon his counsel. Additionally, [one director's] law firm derived a substantial portion of its revenue from Meyerson and his businesses. Given the state of the record, however, we cannot say whether or not the other Directors acted independently or were beholden to Meyerson such that they deferred to his will in the [challenged transaction].[98]

The Delaware Supreme Court held that the shareholders' contentions "represent[ed] a disputed fact that should be resolved only after a trial at which all the facts are presented and the credibility of all the witnesses tested."[99] The court noted that "[o]nly after a full picture of Meyerson's relationship with the other Directors is developed can their independence be ascertained."[100] Therefore, both the duty-of-care claim and the duty-of-loyalty claim survived the pretrial motion for summary judgment.

In another recent case, *Levco Alternative Fund Ltd. v. Reader's Digest Ass'n*,[101] the plaintiffs sought a preliminary injunction based on allegations that the directors breached their fiduciary duty of loyalty in approving a proposed recapitalization.[102] The Delaware Chancery Court denied a preliminary injunction, concluding that the plaintiffs had not established a likelihood of success on the merits of their fiduciary-duty claim because the evidence did not suggest that the directors lacked independence or that the transaction was unfair to the stockholders.[103] The Delaware Supreme Court reversed, holding that the plaintiffs had rebutted the business judgment rule presumption because the directors were not disinterested.[104] Thus, the directors bore the burden of "establishing entire fairness" as "the party who stands on both sides of the transaction."[105]

98. *Id.* at 264–65.

99. *Id.* at 265.

100. *Id.* The Delaware Supreme Court also reversed the Delaware Chancery Court's grant of summary judgment to the directors on the plaintiffs' allegation that the compensation paid to the directors during this period was excessive, stating that directors must make "an affirmative showing that the compensation arrangements are fair to the corporation." *Id.* at 265–66.

101. Nos. 466,2002 & 467,2002, 2002 WL 1859064 (Del. Aug. 13, 2002).

102. *Id.* at *1.

103. *Id.* at *1–2.

104. *Id*. at *2.

105. *Id.*

In *Omni Care, Inc. v. NCS Healthcare, Inc.*,[106] the Delaware Supreme Court reversed the denial of a preliminary injunction, finding that the director-defendants had breached their fiduciary duties by agreeing to merge with Genesis Health Ventures, Inc.[107] The court found that the directors "irrevocably locked up" the merger "by approving the Voting Agreements [that] assured shareholder approval" and "by agreeing to a provision requiring that the merger be presented to the shareholders."[108] The court concluded that these actions "precluded the directors from exercising their continuing fiduciary obligation to negotiate a sale of the company in the interest of the shareholders."[109]

In re National Auto Credit, Inc. Shareholders Litigation[110] involved allegations that the directors' decision on the company's CEO's compensation constituted waste because (1) "the relative size of the compensation" was disproportionate in comparison to the value of the company, (2) the company "no longer ha[d] an active business to manage," and (3) the company "was paying [the CEO] essentially to sit idle."[111] In response, the directors moved to dismiss the case, claiming that their compensation decisions were "protected by the business judgment rule."[112] The Delaware Chancery Court refused to dismiss the plaintiffs' waste allegations on business judgment rule grounds.[113]

As demonstrated by these recent cases, among others,[114] the Delaware

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106. Nos. 605,2002 & 649,2002, 2002 WL 31767892 (Del. Dec. 10, 2002).

107. *Id.* at *2.

108. *Id.*

109. *Id.*

110. No. Civ. A. 19028, 2003 WL 139768 (Del. Ch. Jan. 10, 2003).

111. *Id.* at *14.

112. *Id.*

113. *Id.* at *15.

114. Other Delaware cases also reflect this trend of denying pretrial motions asserting the business judgment rule defense and permitting the plaintiffs to reach the discovery stage. *See, e.g.*, *In re* InfoUSA, Inc. S'holders Litig., No. Civ. A 1956-CC, 2006 WL 2419661, at *23 (Del. Ch. Aug. 20, 2007) (denying a motion to dismiss for failure to state a claim by finding that the complaint stated a claim for self-dealing transactions); *In re* Tyson Foods, Inc. Consol. S'holder Litig., 919 A.2d 563, 593 (Del. Ch. 2007) (denying a motion to dismiss for failure to state a claim, in part, finding that the plaintiffs had adequately alleged breaches of the fiduciary duties of loyalty and good faith); Ryan v. Gifford, 918 A.2d 341, 358 (Del. Ch. 2007) (denying a motion to dismiss for failure to state a claim and stating that the shareholder's allegations of breach of fiduciary duty were sufficient to rebut the business judgment rule); Sample v. Morgan, 914 A.2d 647, 669 (Del. Ch. 2007) (denying a motion to dismiss for failure to state a claim and finding the allegation of waste sufficient to overcome the presumption of the business judgment rule); *In re* Primedia Inc. Derivative Litig., 910 A.2d 248, 250 (Del. Ch. 2006) (denying a motion to dismiss for failure to state a claim because the court could reasonably infer self-dealing in breach of the duty of loyalty); Feldman v. Cutaia, Civ. A. No. 1656-N, 2006 WL 920420, at *1–2 (Del. Ch. Apr. 5, 2006) (denying a motion to dismiss for failure to state a claim on claims of breach of the duty of loyalty and the duty of candor); *In re* LNR Prop. Corp. S'holders Litig., 896 A.2d 169, 171 (Del. Ch. 2005) (denying a motion to dismiss for failure to state a claim because the complaint stated a breach-of-fiduciary-duty claim); Orloff v. Shulman, No. Civ. A. 852-N, 2005 WL 3272355, at *13–14 (Del.

courts now more closely scrutinize directors' assertions of the business judgment rule in pretrial motions. The Delaware courts' rulings on the pretrial motions in these cases also show an increased willingness to allow shareholder-plaintiffs the opportunity to reach discovery and potentially trial in cases that would have traditionally ended on pretrial motions asserting the business judgment rule.

IV. HOW THE DELAWARE COURTS HAVE LOWERED THE HURDLES OF SHAREHOLDER DERIVATIVE LITIGATION WITHOUT CHANGING THE LIABILITY STANDARDS

In these recent Delaware cases, the courts did not announce any new standards of legal liability. The courts did not state any new standards for applying the business judgment rule or evaluating alleged fiduciary-duty breaches in pretrial motions. Instead, the courts relied on their prior broad descriptions of directors' fiduciary duties to deny pretrial motions asserting the business judgment rule. These courts also ignored their historically narrow analyses of alleged breaches of those duties and their past deferential view of directors' assertions of the business judgment rule.

This Part explains the fiduciary duties of care, loyalty, and good faith[115] that underlie the business judgment rule, and the categories to which the rule does not apply. This Part also contrasts the courts' high standards of conduct for directors' fiduciary duties and the much lower standards of liability for evaluating alleged breaches of those duties. *Disney* demonstrates this contrast as both the Delaware Supreme Court and the Delaware Chancery Court recognized two different standards: the best corporate practices that directors should comply with when making decisions and the lower legal liability standard that directors will be judged against in litigation. Although both courts determined that Disney's directors did not comply with best corporate practices and rejected the pretrial assertions of the business judgment rule, both courts ultimately agreed that the directors did not breach any fiduciary duty and thus were entitled to the protection of the business judgment rule.[116]

Ch. Nov. 23, 2005) (denying a motion to dismiss in part by finding that the plaintiffs should have the opportunity to conduct discovery on their claims of waste and breaches of fiduciary duty); *In re* Freeport-McMoran Sulphur, Inc. S'holder Litig., No. Civ. A. 16729, 2005 WL 1653923, at *1 (Del. Ch. June 30, 2005) (denying the defendants' motion for summary judgment where the complaint alleged that directors breached their fiduciary duties by approving a merger); Tooley v. AXA Fin., Inc., No. 18414, 2005 WL 1252378, at *7 (Del. Ch. May 13, 2005) (denying a motion to dismiss and ruling that the plaintiff had "overcome the presumption of the business judgment rule").

115. *See* Brehm v. Eisner (*In re* Walt Disney Co. Derivative Litig.) (*Disney VI*), 906 A.2d 27, 52 (Del. 2006); *see also* Emerald Partners v. Berlin, 787 A.2d 85, 90–91 (Del. 2001) (describing a "triad of fiduciary duties: due care, loyalty, [and] good faith").

116. *Disney VI*, at 55; *id.* at 56 (comparing what happened in *Disney* "to what would have occurred had the committee followed a 'best practices' (or 'best case') scenario").

A. *The Duty of Care*

Courts have explained the standard of conduct imposed by the duty of care in a variety of ways. Basically, the duty places an affirmative obligation on the directors to protect the interests of the corporation and its shareholders when making decisions on behalf of the corporation. Thus, directors must critically assess relevant information before making a decision.[117] Courts have stated that the duty of care requires directors to "'use that amount of care which ordinarily careful and prudent men would use in similar circumstances'" and to "'consider all material information reasonably available' in making business decisions."[118] Consequently, courts frequently state that directors breach the duty of care by failing "to act in an informed and deliberate manner" when making a decision on behalf of the corporation.[119] One court has indicated that directors may breach the duty of care by failing to review financial statements or to have a rudimentary understanding of corporate affairs.[120] Similarly, when a director approves a transaction without determining whether the value given by the corporation equals or exceeds the value received, the director may breach the duty of care.[121] Some courts have endorsed a stronger formulation of the duty of care, stating that a board's decision will be upheld unless the decision cannot be "'attributed to any rational business purpose.'"[122] Thus, these courts indicate that the business judgment rule does not protect irrational decisions.[123]

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117. *See* Briggs v. Spaulding, 141 U.S. 132, 147 (1891) (stating that directors have a duty to "supervise the business with attention . . . [and] to use proper care in the appointment of agents"); *see also* Fairfax, *supra* note 8, at 397 ("[D]irectors have an obligation to monitor corporate actors and remain informed about corporate operations."); Veasey, *supra* note 1, at 445 ("[I]t goes without saying that directors must be careful and work hard to understand the facts behind that which they are deciding.").

118. *In re* Walt Disney Co. Derivative Litig. (*Disney V*), 907 A.2d 693, 749 (Del. Ch. 2005) (quoting Graham v. Allis-Chalmers Mfg. Co., 188 A.2d 125, 130 (Del. 1963) and Brehm v. Eisner (*Disney II*), 746 A.2d 244, 259 (Del. 2000)), *aff'd*, 906 A.2d 27, 55 (Del. 2006); *see* Smith v. Van Gorkom, 488 A.2d 858, 873 (Del. 1985) (stating that directors have a duty to "act in an informed and deliberate manner"); Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) ("[D]irectors have a duty to inform themselves, prior to making a business decision, of all material information reasonably available to them."), *overruled on other grounds by Disney II*, 746 A.2d 244.

119. *Van Gorkom*, 488 A.2d at 873 ("Under the business judgment rule there is no protection for directors who have made 'an unintelligent and unadvised judgment.'" (quoting Mitchell v. Highland-W. Glass Co., 167 A. 831, 833 (Del. Ch. 1933))); *see* Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 371 (Del. 1993) (holding that directors violated their duty of care because they were not "adequately inform[ed]" of all reasonably available material information before approving a merger agreement).

120. Francis v. United Jersey Bank, 432 A.2d 814, 821–22 (N.J. 1981).

121. *See* McMullin v. Beran, 765 A.2d 910, 922 (Del. 2000).

122. Brehm v. Eisner (*In re* Walt Disney Co. Derivative Litig.) (*Disney VI*), 906 A.2d 27, 74 (Del. 2006) (quoting Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971)).

123. *See id.*; *see also Disney II*, 746 A.2d at 264 ("Irrationality is the outer limit of the

In analyzing an alleged breach of the duty of care, however, the Delaware courts interpret the standard of conduct to require only procedural due care.[124] By focusing on procedural due care, courts review the *process* that the board used to reach the decision and not the *merits* of the decision.[125] The focus on procedure has a profound effect on litigation because courts "insulate directors from liability whenever [directors] make even a modest attempt to follow the appropriate formalities."[126] Indeed, some courts have interpreted this emphasis on process as requiring an analysis of the time a board devoted to discussing a particular decision as if there exists some talismanic number of minutes.[127] Boards of directors, taking note of the focus on process, can document their decision-making processes with thorough board minutes that reflect careful and deliberative procedures. Skeptics, however, argue that focusing on process leads merely to "play acting and . . . paper trails" but "does not improve the quality of decisions that are made."[128]

The Delaware courts further reduced the standard of conduct by stating that "deficiencies in the directors' process are actionable only if the directors' actions are grossly negligent."[129] Gross negligence in this context has been defined as a "'reckless indifference to or a deliberate disregard of the whole body of stockholders' or actions which are 'without

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business judgment rule." (footnote omitted)); AC Acquisitions Corp. v. Anderson, Clayton & Co., 519 A.2d 103, 111 n.9 (Del. Ch. 1986) ("[A] decision by disinterested directors following a deliberative process may still be the basis for liability if such decision cannot be 'attributed to any rational business purpose,' or is 'egregious.'" (citation omitted) (quoting *Sinclair*, 280 A.2d at 720)).

124. *Van Gorkom*, 488 A.2d at 874–88.

125. *Disney II*, 746 A.2d at 262–64 (holding that the business judgment rule requires "*process* due care"); Bainbridge, *supra* note 40, at 92 ("*Van Gorkom* thus established a requirement of what might be called procedural or process due care as a prerequisite for invoking the business judgment rule.").

126. Margaret M. Blair & Lynn A. Stout, *Trust, Trustworthiness, and the Behavioral Foundations of Corporate Law*, 149 U. PA. L. REV. 1735, 1790 (2001).

127. This time-oriented analysis began in *Van Gorkom*, where the court noted that the board reached its decision after only two hours of deliberation based on a twenty-minute oral presentation. *See Van Gorkom*, 488 A.2d at 868–69; *see, e.g.*, Kumar v. Racing Corp. of Am., Civ. A. No. 12039, 1991 WL 67083, at *6 (Del. Ch. Apr. 26, 1991) (finding that the plaintiffs were likely to prevail on a duty-of-care claim because the board meeting was "short, almost to the point of being perfunctory," no documents were distributed, no financial analysis was presented, and only a brief discussion occurred before the vote).

128. Branson, *supra* note 46, at 639–40 ("The business judgment rule's emphasis on the process leading to formal judgments also constitutes make-work for lawyers who, as process engineers, come to have a larger role than they should have in the board room. Similarly, critics of the modern business judgment rule say that insistence on formal decisions places a premium on play acting and on paper trails. It does not improve the quality of decisions that are made.").

129. *In re* Walt Disney Co. Derivative Litig. (*Disney V*), 907 A.2d 693, 749 (Del. Ch. 2005), *aff'd*, 906 A.2d 27 (Del. 2006).

the bounds of reason.'"[130]

> [W]hether a judge or jury considering the matter after the fact, believes a decision substantively wrong, or degrees of wrong extending through "stupid" to "egregious" or "irrational", provides no ground for director liability, so long as the court determines that the process employed was either rational or employed in *a good faith* effort to advance corporate interests. To employ a different rule—one that permitted an "objective" evaluation of the decision—would expose directors to substantive second guessing by ill-equipped judges or juries, which would, in the long-run, be injurious to investor interests. Thus, the business judgment rule is process oriented and informed by a deep respect for all *good faith* board decisions.
>
> . . . Where a director *in fact exercises a good faith effort to be informed and to exercise appropriate judgment*, he or she should be deemed to satisfy fully the duty of attention.[131]

Combining the focus on procedural due care with the gross negligence standard has an easily identifiable effect—courts almost never impose financial liability on directors for breaching the duty of care.[132]

Disney highlights the disparity between the Delaware courts' stated standard of conduct for the duty of care and the lower standard of liability with respect to breaches of the duty of care. In *Disney*, the Delaware Chancery Court stated that liability for a loss may flow from an "'ill advised or negligent'" decision, or "'from an *unconsidered failure of the board to act* in circumstances in which due attention would, arguably, have prevented the loss.'"[133] Analyzing the facts, the Delaware Chancery Court and the Delaware Supreme Court stated that Disney's directors did not comply with corporate best practices.[134] As to Ovitz's no-cause

130. Tomczak v. Morton Thiokol, Inc., Civ. A. No. 7961, 1990 WL 42607, at *12 (Del. Ch. Apr. 5, 1990) (quoting Allaun v. Consol. Oil Co., 147 A. 257, 261 (Del. Ch. 1929)).

131. *In re* Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 967–68 (Del. Ch. 1996) (footnote omitted).

132. *See Disney V*, 907 A.2d at 750 ("[D]uty of care violations are rarely found."); *see also* Fairfax, *supra* note 8, at 407–08 ("Over the last twenty years, a variety of mechanisms have contributed to a virtual elimination of legal liability for directors who breach their duty of care under state law."); Loewenstein, *supra* note 26, at 369 ("*Van Gorkom* is famous, of course, because it marked one of the few times that a court found directors liable for breach of the duty of care."); *cf.* Stuart R. Cohn, *Demise of the Director's Duty of Care: Judicial Avoidance of Standards and Sanctions Through the Business Judgment Rule*, 62 TEX. L. REV. 591, 591 nn.1–2 (1983) (noting only seven cases holding directors liable for all breaches of fiduciary duty (other than in the context of self-interested transactions)).

133. *Disney V*, 907 A.2d at 749 (quoting *In re Caremark*, 698 A.2d at 967).

134. Brehm v. Eisner (*In re* Walt Disney Co. Derivative Litig.) (*Disney VI*), 906 A.2d 27,

termination, which resulted in a $140 million payout to Ovitz, the Delaware Chancery Court stated the following:

> Thus, as of December 12, Ovitz was officially terminated without cause. Up to this point, however, the Disney board had never met in order to vote on, or even discuss, the termination at a full session, and few if any directors did an independent investigation of whether Ovitz could be terminated for cause. As a result, the Disney directors had been taken for a wild ride, and most of it was in the dark.[135]

However, despite concluding that Disney's directors had neither fulfilled the standard of conduct nor followed best practices, the courts held that the directors had not breached the duty of care and thus imposed no legal liability on the directors.[136]

The facts of *Disney* strongly resemble those of *Smith v. Van Gorkom*,[137] which is virtually the only Delaware opinion holding directors liable for breaching their duty of care.[138] Van Gorkom, the CEO of Trans Union, approached Jay Pritzker and offered to sell Trans Union at $55 per share when the market price was about $38 per share.[139] Pritzker accepted subject to certain conditions, which included limiting Trans Union's freedom to shop around for a better offer.[140] Van Gorkom presented the deal to Trans Union's board in a twenty-minute oral presentation.[141] The board did not receive a written summary of the proposed merger agreement, studies, or any other documents.[142] After deliberating for only two hours, the board voted to approve the offer.[143] The Delaware Supreme Court ultimately held that the directors violated their duty of care by failing to adequately investigate the offer[144] because they had not valued the company, sought expert advice, or solicited other offers.[145] In *Van*

55–56 (Del. 2006); *Disney V*, 907 A.2d at 697.

135. *Disney V*, 907 A.2d at 736.

136. *See id*. at 697; *see also Disney VI*, 906 A.2d at 60.

137. 488 A.2d 858 (Del. 1985).

138. *See id.* at 893; *see also* Loewenstein, *supra* note 26, at 369.

139. *Van Gorkom*, 488 A.2d at 865–67.

140. *Id.* at 867–68.

141. *Id.* at 868.

142. *Id.* at 874.

143. *Id.* at 869.

144. *Id.* at 893; *id.* at 874 ("The directors (1) did not adequately inform themselves as to Van Gorkom's role in forcing the 'sale' of the Company and in establishing the per share purchase price; (2) were uninformed as to the intrinsic value of the Company; and (3) given these circumstances, at a minimum, were grossly negligent in approving the 'sale' of the Company upon two hours' consideration, without prior notice, and without the exigency of a crisis or emergency.").

145. *Id.* at 876–79. *But see id.* at 894–96 (McNeilly, J., dissenting) (noting the directors'

Gorkom, the court stated that the business judgment rule does not protect an uninformed decision.[146] Further, the court concluded that directors may be held liable for breaching their duty of care if the plaintiff shows that the directors were grossly negligent in failing to inform themselves of all material information reasonably available to them.[147]

The Delaware Legislature acted quickly to lessen *Van Gorkom*'s impact by enacting § 102(b)(7),[148] which permits corporations to limit or eliminate director liability for breaches of the duty of care (but not for breaches of loyalty or good faith).[149] All states currently have statutes allowing corporations to limit or eliminate personal liability for directors for duty-of-care breaches.[150] These statutes insulate directors from financial liability for breaching their duty of care and also allow directors to obtain dismissal of lawsuits in which a plaintiff alleges only a duty-of-care violation.[151] Although these statutes effectively limit the impact of the duty of care,[152] it still has relevance for (1) those corporations that have not adopted such provisions, (2) those plaintiffs seeking only injunctive relief for an alleged duty-of-care breach, and (3) those plaintiffs alleging a breach of the duty of care along with breaches of other fiduciary duties.

Many commentators believed that the *Disney* case presented an opportunity for the Delaware Supreme Court to address *Van Gorkom*'s continued validity.[153] The Delaware Supreme Court, however, did not even

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sophistication, their thorough knowledge of the company, the premium over market price, and an investment banking firm's failure to find another buyer).

146. *Id.* at 872 (majority opinion).

147. *Id.*

148. Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1156, 1166 n.18 (Del. 1995) (noting that § 102(b)(7) was enacted in response to *Van Gorkom*); Loewenstein, *supra* note 26, at 369 ("[*Van Gorkom*] motivated the Delaware legislature (at the prompting of the corporate law committee of the Delaware bar) to enact legislation that allowed Delaware corporations to exempt directors from monetary damages for breaches of the duty of care."); Veasey, *supra* note 1, at 447 (noting that *Van Gorkom* led to the enactment of § 102(b)(7)).

149. DEL. CODE ANN. tit. 8, § 102(b)(7) (2008).

150. Fairfax, *supra* note 8, at 412 (citing J. Robert Brown, Jr., *The Irrelevance of State Corporate Law in the Governance of Public Companies*, 38 U. RICH. L. REV. 317, 332 n.93 (2004)).

151. Emerald Partners v. Berlin, 787 A.2d 85, 91 (Del. 2001); Malpiede v. Townson, 780 A.2d 1075, 1095–96 (Del. 2001). In addition, as Professor Fairfax has noted, "The combination of indemnification provisions and [directors' and officers'] insurance essentially eliminates directors' financial liability for breaching their fiduciary obligations." Fairfax, *supra* note 8, at 414.

152. Future research should explore the continuing advisability of exculpatory statutes for both public and private corporations.

153. *See, e.g.*, Christine Hurt, *More Disney: Where Did That* Van Gorkom *Case Go?*, CONGLOMERATE BLOG: BUS. L. ECON. & SOC'Y, June 9, 2006, http://www.theconglomerate.org/2006/06/more_disney_whe.html ("I searched the opinion—no '*Van Gorkom*.' There's not even a '*Gorkom*.' So, the Supreme Court of Delaware issues an opinion in an appeal that has everyone asking 'Is *Van Gorkom*' Dead?' and does not even cite *Van Gorkom*?") (formatting added).

cite *Van Gorkom* in the *Disney* opinion.[154] It remains to be seen whether *Disney* signals the death of *Van Gorkom*[155] or whether *Van Gorkom* may be resurrected in future cases.[156] Until the Delaware Supreme Court settles the debate, *Van Gorkom* remains a thread on which plaintiffs' attorneys can cling in alleging breaches of the duty of care and in defending against defendants' pretrial assertions of the business judgment rule. Even *Disney*, in which the directors ultimately avoided liability, presents such threads in its broad language regarding best practices and the standard of conduct for the duty of care.

B. *The Duty of Loyalty*

Like with the duty of care, courts broadly state the standard of conduct for the duty of loyalty but then apply a much lower standard of liability to alleged breaches of that duty. The duty of loyalty "mandates that the best interest of the corporation and its shareholders takes precedence over any interest possessed by a director, officer or controlling shareholder and not shared by the stockholders generally."[157] Specifically, a director must exercise independent judgment, and the director must be disinterested in the outcome.[158] The Delaware Chancery Court in *Disney* described the duty of loyalty by quoting from a seminal case, *Guth v. Loft, Inc.*[159]:

154. Brehm v. Eisner (*In re* Walt Disney Co. Derivative Litig.) (*Disney VI*), 906 A.2d 27 (Del. 2006).

155. *See, e.g.*, Larry Ribstein, *The* Disney *Affirmance: The End of the SOX Era?*, IDEOBLOG, June 8, 2006, http://busmovie.typepad.com/ideoblog/2006/06/the_disney_affi.html ("*Van Gorkom* is still dead. Of course there's still gross negligence liability, but not a la *Van Gorkom*.").

156. *See* Steve Bainbridge, *Is Van Gorkom Dead*, CONGLOMERATE BLOG: BUS. L. ECON. & SOC'Y, Aug. 11, 2005, http://www.theconglomerate.org/2005/08/is_van_gorkom_d.html (responding to the Delaware Chancery Court's opinion and disagreeing with the proposition that *Van Gorkom* is dead); Hurt, *supra* note 153 (discussing why the Delaware Supreme Court did not expressly reject *Van Gorkom*); Larry Ribstein, *Is Van Gorkom Dead?*, CONGLOMERATE BLOG: BUS. L. ECON. & SOC'Y, Aug. 11, 2005, http://www.theconglomerate.org/2005/08/is_van_gorkom_d_1.html ("So does *Van Gorkom* have any kind of a pulse? Maybe, in the following limited sense: No case ever dies in Delaware. Often cases are preserved as alternative tools the court can draw from as the facts and times require. At worst, cases go into suspended animation, to be dug up for freakish facts when none of the cases in current 'inventory' are useful.").

157. Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 361 (Del. 1993); Weinberger v. UOP, Inc., 457 A.2d 701, 710 (Del. 1983).

158. *See Cede*, 634 A.2d at 362; *see also* Orman v. Cullman, 794 A.2d 5, 22 (Del. Ch. 2002) (stating that the business judgment rule is rebutted where a majority of the directors either were "interested in the outcome of the transaction or lacked the independence to consider objectively whether the transaction was in the best interest of its company and all of its shareholders").

159. 5 A.2d 503 (Del. 1939).

> Corporate officers and directors are not permitted to use their position of trust and confidence to further their private interests. . . . A public policy, existing through the years, and derived from a profound knowledge of human characteristics and motives, has established a rule that demands of a corporate officer or director, peremptorily and inexorably, the most scrupulous observance of his duty, not only affirmatively to protect the interests of the corporation committed to his charge, but also to refrain from doing anything that would work injury to the corporation, or to deprive it of profit or advantage which his skill and ability might properly bring to it, or to enable it to make in the reasonable and lawful exercise of its powers. The rule that requires an undivided and unselfish loyalty to the corporation demands that there be no conflict between duty and self-interest.[160]

A director is "interested" in the outcome of a decision where the director "will receive a personal financial benefit from [the] transaction that is not equally shared by the stockholders."[161] A director is also "interested" where the "corporate decision will have a materially detrimental impact on a director, but not on the corporation and the stockholders."[162] The benefit need not be financial; directors are "interested" where they "receive[] a substantial benefit from supporting a transaction."[163] Examples of self-interested breaches of the duty of loyalty include self-dealing, excessive compensation, use of corporate funds to perpetuate control, insider trading, usurping corporate opportunities, and competition by corporate officers and directors with their corporation.[164]

Independence, on the other hand, requires that "the director's decision is based entirely on the corporate merits of the transaction and is not influenced by personal or extraneous considerations."[165] The current common-law definition of "independence" focuses on familial or close personal relationships.[166] In other words, if a director's son stands on the other side of a proposed contract with the corporation, courts assume that

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160. *In re* Walt Disney Co. Derivative Litig. (*Disney V*), 907 A.2d 693, 751 (Del. Ch. 2005) (alteration in original) (quoting *Guth*, 5 A.2d at 510), *aff'd*, 906 A.2d 27 (Del. 2006).

161. Rales v. Blasband, 634 A.2d 927, 936 (Del. 1993).

162. *Id.*

163. *Cede*, 634 A.2d at 362.

164. *See* BAINBRIDGE, *supra* note 25, §§ 7.1–7.2, at 306–07, §§ 7.2–7.3, at 321–23.

165. *Cede*, 634 A.2d at 362; *see also* Telxon Corp. v. Meyerson, 802 A.2d 257, 264 (Del. 2002) ("Directors must not only be independent, but must act independently."); *Rales*, 634 A.2d at 935 ("[T]he board must be able to act free of personal financial interest and improper extraneous influences.").

166. *Telxon*, 802 A.2d at 264.

director cannot act independently. Plaintiffs may also show lack of independence by proving that a director is "controlled" by or "beholden" to the interested directors, or so influenced by the interested directors that the "independent" director's discretion is compromised.[167] A director is "controlled" or "beholden" when the controlling party has the

> direct or indirect unilateral power to decide whether the director continues to receive a benefit upon which the director is so dependent or is of such subjective material importance that its threatened loss might create a reason to question whether the director is able to consider the corporate merits of the challenged transaction objectively.[168]

In analyzing alleged breaches of the duty of loyalty, however, the Delaware courts interpret the standard of liability more narrowly. For instance, courts rarely find that a director is controlled by another.[169] As one court stated:

> To create a reasonable doubt about an outside director's independence, a plaintiff must plead facts that would support the inference that because of the nature of a relationship or additional circumstances other than the interested director's stock ownership or voting power, the non-interested director would be more willing to risk his or her reputation than risk the relationship with the interested director.[170]

Further, courts never find non-familial relationships alone to be bias-producing.[171] The recent corporate scandals, however, suggest that independence may be threatened by more than familial relationships.[172]

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167. *Id.*; *see also* Beam *ex rel*. Martha Stewart Living Omnimedia, Inc. v. Stewart, 845 A.2d 1040, 1050 (Del. 2004); *Rales*, 634 A.2d at 936.

168. *Telxon*, 802 A.2d at 264; *see also Cede*, 634 A.2d at 362 ("[A] director who receives a substantial benefit from supporting a transaction cannot be objectively viewed as disinterested or independent.").

169. Branson, *supra* note 46, at 642 ("A plaintiff making [a dominated-director case] faces an uphill battle. Courts are loathe to find that an otherwise reputable business person is not his or her own person.").

170. *Beam*, 845 A.2d at 1052.

171. *Cf.* Kenneth B. Davis, Jr., *Structural Bias, Special Litigation Committees, and the Vagaries of Director Independence*, 90 IOWA L. REV. 1305, 1307–15 (2005) (noting that almost all courts reject the notion of inevitable structural bias, which theorizes that due to business, social, and other relationships, directors cannot independently serve on an SLC).

172. The independence of directors may also be affected by the high salaries that some corporations pay their directors because the salaries may silence any dissent. SKEEL, *supra* note 7,

Although the directors at Enron and WorldCom would likely be considered independent under the traditional common-law definitions, the directors' relationships, such as close friendships or business relationships, suggested a lack of true independence.[173]

Courts, however, state that "[a]llegations of mere personal friendship or a mere outside business relationship, standing alone, are insufficient to raise a reasonable doubt about a director's independence."[174] For example, in *Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart*, allegations that Martha Stewart and other directors "moved in the same social circles, attended the same weddings, developed business relationships before joining the board, and described each other as 'friends,' even when coupled with Stewart's 94% voting power, [were] insufficient, without more, to rebut the presumption of independence."[175] In fact, the court stated that "[w]hether they arise before board membership or later as a result of collegial relationships among the board of directors, such affinities—standing alone—will not" rebut the presumption of independence.[176] Such allegations also did "not provide a sufficient basis from which reasonably to infer" that other directors were beholden to Stewart.[177]

Courts also do not view structural bias as actionable.[178] Structural bias is defined as "the predilection of directors to favor those of the same social or economic class, such as fellow directors or senior managers."[179] The

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at 165. Directors may also be silenced by a charismatic CEO. *Id.*

173. *Id.* at 164 ("Cronyism may have been part of the reason that WorldCom's board let Bernie Ebbers do whatever he wanted. The inner circle on the board consisted of the managerial directors . . . and several of Bernie's childhood friends. . . . [T]he Enron directors don't look quite so robustly independent. Several of the directors had direct financial ties to Enron . . . . [and] others worked for non-profits . . . that received six-figure donations from Enron during their tenures on the board. It doesn't take a conspiracy theorist to suspect that directors with these kinds of ties might be reluctant to ask hard questions about the company that has been so kind to their institution.").

174. *Beam*, 845 A.2d at 1050; Crescent/Mach I Partners, L.P. v. Turner, 846 A.2d 963, 980–81 (Del. Ch. 2000) (finding an allegation that a director was controlled by another director because of their fifteen-year professional and personal relationship was insufficient to raise a reasonable doubt as to independence); Benerofe v. Cha, No. 14614, 1998 WL 83081, at *3 (Del. Ch. Feb. 20, 1998) (finding that conclusory allegations of long-standing friendship do not raise a reasonable doubt about whether a director could exercise independent business judgment); *In re* Grace Energy Corp. S'holders Litig., Civ. A. No. 12,464, 1992 WL 145001, at *4 (Del. Ch. June 26, 1992) ("[T]he Delaware Supreme Court has made it clear that conclusory allegations of such personal affinity alone are not sufficient to establish director interest. Actual financial interest must be shown.").

175. *Beam*, 845 A.2d at 1051 (analyzing the directors' independence and the business judgment rule's applicability to decide whether demand was excused).

176. *Id.*

177. *Id.*

178. Davis, *supra* note 171, at 1307–15.

179. Branson, *supra* note 46, at 641–42.

structural-bias argument is most compelling in the SLC context, where the directors on the SLC recommend that a derivative suit not continue against fellow directors.[180] The typical motivation behind such a recommendation has been referred to as "'there but for the grace of God go I' empathy."[181]

Sarbanes–Oxley and the requirements adopted by the NYSE and NASDAQ define when directors are not independent and disinterested.[182] These new definitions, however, follow the narrow standards of liability set by the Delaware courts.[183] Moreover, these definitions will not affect the performance of most boards because most large corporations' boards already consist of a majority of independent directors even according to the new definitions.[184] For example, "[a]ll but two of Enron's directors were disinterested, and Enron had disinterested audit and compensation committees, yet the directors simply nodded their heads as [Ken] Lay and Jeff Skilling spun their web of magnificent promises and prophecies."[185] Consequently, the same standard of liability for duty-of-loyalty breaches applies under both Delaware common law and these regulatory definitions.

C. *The Duty of Good Faith*

The duty of good faith is perhaps the most elusive of the fiduciary duties. Although the term "good faith" appears in early business judgment rule cases, it rarely served as a basis of decision.[186] An early judicial explanation of the business judgment rule stated that "'a Board of Directors acting in *good faith* and with reasonable care and diligence, who nevertheless fall into a mistake, either as to law or fact, are not liable for the consequences of such mistake.'"[187] Other courts define the business judgment rule in relation to "bad faith": "'In the absence of a showing of *bad faith* on the part of the directors or of a gross abuse of discretion the

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180. *See supra* Part II.A (discussing SLCs).

181. Zapata Corp. v. Maldonado, 430 A.2d 779, 787 (Del. 1981).

182. Sarbanes–Oxley Act of 2002, § 301, 15 U.S.C. § 78j-1(m) (Supp. IV 2004); NYSE, Inc., Listed Company Manual § 303A.02 (2004) (stating that a director is not independent if, among other things, the director has a material relationship with the listed company, has been an employee of the listed company within the last three years, or has an immediate family member who has been an executive officer of the listed company within the last three years); NASDAQ, Inc., Marketplace Rules R. 4200(a)(15) (2004) (similar definitions).

183. *See* Telxon Corp. v. Meyerson, 802 A.2d 257, 264–65 (Del. 2002) (noting the current common-law definition of "independence" and its requirements).

184. *See* SKEEL, *supra* note 7, at 183 ("Most large corporations already have a majority of disinterested directors on their boards. The Business Roundtable, a group of executives from the nation's leading companies, has been promoting this strategy since 1990, and institutional investors such as [the California Public Employees' Retirement System] have made disinterestedness a major focus of their corporate-governance initiatives.").

185. *Id.* at 184.

186. *See* Arsht, *supra* note 52, at 99.

187. *Id.* (emphasis added) (quoting Hodges v. New Eng. Screw Co., 3 R.I. 9, 18 (1853)).

business judgment of directors will not be interfered with by the courts.'"[188] Courts also refer to good faith when explaining the duties of loyalty and care. For instance, one formulation of the duty of loyalty states that independent and disinterested directors will not be "liable for a breach of that duty, unless the facts of the transaction are 'such that no person could possibly authorize [it] if he or she were attempting in good faith to meet their duty.'"[189]

The Delaware Supreme Court's recent *Disney* opinion suggested that good faith constituted a separate fiduciary duty,[190] although the court explained the duty of good faith by referring to incidents of "bad faith." As the Delaware Chancery Court in *Disney* stated:

> 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.[191]

In a previous opinion in the *Disney* litigation, the Chancery Court stated that directors act in bad faith if they "*consciously and intentionally disregarded their responsibilities*, adopting a 'we don't care about the risks' attitude concerning a material corporate decision."[192]

The Delaware Supreme Court accepted the Chancery Court's definitions of "bad faith."[193] Recognizing that the duty of good faith is a relatively undeveloped concept in corporate law yet an increasingly important one, the Delaware Supreme Court also gave "some conceptual guidance to the corporate community" on the meaning of the duty of good faith.[194] The court identified two categories of fiduciary behavior that fit

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188. *Id*. at 108 (emphasis added) (quoting Warshaw v. Calhoun, 221 A.2d 487, 492–93 (Del. 1966)).

189. Hillary A. Sale, *Delaware's Good Faith*, 89 CORNELL L. REV. 456, 483–84 (2004) (alteration in original) (quoting Gagliardi v. Trifoods Int'l, Inc., 683 A.2d 1049, 1053 (Del. Ch. 1996)).

190. Brehm v. Eisner (*In re* Walt Disney Co. Derivative Litig.) (*Disney VI*), 906 A.2d 27, 52 (Del. 2006); Veasey, *supra* note 1, at 447 ("[I]t seems that there is a separate duty of good faith, not only arising out of our case law, but also as a matter of statutory construction.").

191. *In re* Walt Disney Co. Derivative Litig. (*Disney V*), 907 A.2d 693, 755 (Del. Ch. 2005) (footnotes omitted), *aff'd*, 906 A.2d 27 (Del. 2006).

192. *In re* Walt Disney Co. Derivative Litig. (*Disney III*), 825 A.2d 275, 289 (Del. Ch. 2003).

193. *Disney VI*, 906 A.2d at 63.

194. *Id.* at 63–64; *see also* Croton River Club, Inc. v. Half Moon Bay Homeowners Ass'n (*In re* Croton River Club, Inc.), 52 F.3d 41, 45 (2d Cir. 1995) ("[T]he business judgment rule does not

the "bad faith" label. "The first category involves so-called 'subjective bad faith,' that is, fiduciary conduct motivated by an actual intent to do harm."[195] The Chancery Court's definition, which involves "intentional dereliction of duty, a conscious disregard for one's responsibilities," captures the second category.[196] The Delaware Supreme Court stated that this category proscribes fiduciary conduct that does not involve disloyalty yet rises above gross negligence.[197] The court rejected the plaintiffs' argument that conduct resulting from gross negligence violates the duty of good faith as well as the duty of care.[198] Based on these definitions of bad faith, both the Delaware Chancery Court and the Delaware Supreme Court held that Disney's directors did not breach their fiduciary duty of good faith.

About a year after *Disney*, the Delaware Supreme Court revisited the duty of good faith in *Stone v. Ritter*, which involved an evaluation of whether demand was excused in a shareholder derivative case.[199] The shareholder-plaintiffs alleged that the directors of AmSouth Bancorporation had failed to ensure that a reasonable compliance and reporting system existed for the corporation and its wholly owned subsidiary, AmSouth Bank.[200] This is known as a director oversight claim or a *Caremark* claim, from *In re Caremark International Derivative Litigation*.[201] In *Caremark*, the court stated that

> where a claim of directorial liability for corporate loss is predicated upon ignorance of liability creating activities within the corporation . . . only a sustained or systematic failure of the board to exercise oversight . . . will establish the lack of good faith that is a necessary condition to liability.[202]

In *Stone*, the Delaware Supreme Court stated that such a claim touches the second category of bad-faith conduct identified in *Disney*—an

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protect actions taken in bad faith . . . ."); W. Point-Pepperell, Inc. v. J.P. Stevens & Co. (*In re* J.P. Stevens & Co. S'holders Litig.), 542 A.2d 770, 780–81 (Del. Ch. 1988) (stating that bad faith may be inferred where the board's decision "is so far beyond the bounds of reasonable judgment that it seems essentially inexplicable on any ground other than bad faith").

195. *Disney VI*, 906 A.2d at 64.

196. *Id.* at 66.

197. *Id.* at 66–67.

198. *Id.* at 64–66.

199. Stone v. Ritter, 911 A.2d 362, 364 (Del. 2006).

200. *Id.* AmSouth Bancorporation and AmSouth Bank paid millions of dollars in fines and civil penalties to resolve government investigations relating to the bank's failure to file Suspicious Activity Reports on the transactions produced by an unlawful "Ponzi" scheme, as required by the federal Bank Secrecy Act and anti-money-laundering regulations. *Id.* at 365–66.

201. 698 A.2d 959 (Del. Ch. 1996).

202. *Id.* at 971.

intentional dereliction of duty or a conscious disregard for one's duties—and declared that this category of bad-faith conduct "is fully consistent with" the lack of good faith conduct that *Caremark* held was necessary for director oversight liability.[203] The court held that a showing of bad-faith conduct "is essential to establish director oversight liability" but that "the fiduciary duty violated by that conduct is the duty of loyalty."[204] Thus, the duty of loyalty "encompasses cases where the fiduciary fails to act in good faith."[205] Consistent with this interpretation, the Delaware Supreme Court stated that "a failure to act in good faith is not conduct that results, *ipso facto*, in the direct imposition of fiduciary liability" but that a "failure to act in good faith may result in liability because the requirement to act in good faith 'is a subsidiary element' . . . 'of the fundamental duty of loyalty.'"[206] Interestingly, the court then made the broad statement that the duty of "good faith does not establish an independent fiduciary duty that stands on the same footing as the duties of care and loyalty."[207]

Exactly how the Delaware courts will analyze alleged breaches of the duty of good faith remains to be seen. The *Stone* opinion strongly suggests that the Delaware Supreme Court is seeking to further narrow the limited duty of good faith recognized in its *Disney* opinion and that it will refuse to recognize an independent duty of good faith when directly confronted with such a claim. Both opinions indicate that the Delaware Supreme Court foresees a limited role for the duty of good faith and that good faith will likely impact only the handful of cases that satisfy the narrow categories of "bad faith" identified by the court.

D. *The Categories to Which the Business Judgment Rule Does Not Apply*

Plaintiffs may also rebut the business judgment rule presumption by showing that the directors failed to make a decision or that the directors' conduct was fraudulent, illegal, or wasteful. It is axiomatic that the business judgment rule applies only to scenarios involving a "business judgment." Thus, the board must actually make a decision to invoke the business judgment rule.[208] The board can decide to act or not to act, but the

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203. *Stone*, 911 A.2d at 369.

204. *Id.* at 370.

205. *Id.*

206. *Id.* at 369–70 (quoting Guttman v. Huang, 823 A.2d 492, 506 n.34 (Del. Ch. 2003)).

207. *Id.* at 370.

208. Aronson v. Lewis, 473 A.2d 805, 813 (Del. 1984) (noting that the business judgment rule does not apply "where directors have either abdicated their functions, or absent a conscious decision, failed to act"), *overruled on other grounds by* Brehm v. Eisner (*Disney II*), 746 A.2d 244 (Del. 2000); Kaplan v. Centex Corp., 284 A.2d 119, 124 (Del. Ch. 1971); Bainbridge, *supra* note

board must have made a conscious decision.[209]

Courts have held that the business judgment rule does not apply to board decisions involving fraud or illegality.[210] Fraud and illegality are excluded from the defense because the board does not have authority to violate the law.

The business judgment rule also does not protect board decisions that waste corporate assets.[211] Yet because a board does not violate the law by wasting corporate assets the reason that the rule does not apply to waste is more difficult to articulate. "[W]aste entails an exchange of corporate assets for consideration so disproportionately small as to lie beyond the range at which any reasonable person might be willing to trade."[212] For example, "a transfer of corporate assets, that serves no corporate purpose" might constitute waste.[213] Similarly, a transfer of corporate assets might constitute waste if no "consideration at all is received."[214] In *Disney*, the Delaware Supreme Court defined waste and the plaintiffs' burden to show waste as follows:

> To recover on a claim of corporate waste, the plaintiffs must shoulder the burden of proving that the exchange was "so one sided that no business person of ordinary, sound judgment

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40, at 99 ("It is well established, for example, that directors may only invoke the business judgment rule when they have made a conscious decision.").

209. *Aronson*, 473 A.2d at 813 ("[A] conscious decision to refrain from acting may . . . be a valid exercise of business judgment and enjoy the protections of the rule."); Rabkin v. Philip A. Hunt Chem. Corp., 547 A.2d 963, 1172 (Del. Ch. 1986) ("The business judgment rule may apply to a deliberate decision not to act . . . .").

210. Paglin v. Saztec Int'l, Inc., 834 F. Supp. 1184, 1200 (W.D. Mo. 1993) ("[T]he business judgment rule does not apply when the act complained of is ultra vires, illegal, or fraudulent."); Shlensky v. Wrigley, 237 N.E.2d 776, 779 (Ill. App. Ct. 1968) ("'The directors are chosen to pass upon [questions of policy and business management] and their judgment unless shown to be tainted with fraud is accepted as final.'" (emphasis omitted) (quoting Davis v. Louisville Gas & Elec. Co., 142 A. 654, 659 (Del. Ch. 1928))); Kamin v. Am. Express Co., 383 N.Y.S.2d 807, 810–11 (Sup. Ct. 1976) (stating that courts will not substitute their judgment for that of directors absent "fraud, dishonesty, or nonfeasance"); Leslie v. Lorillard, 18 N.E. 363, 365 (N.Y. 1888) ("[C]ourts will not interfere unless the [directors'] powers have been illegally or unconscientiously executed; or unless it be made to appear that the acts were fraudulent or collusive, and destructive of the rights of the stockholders.").

211. Brehm v. Eisner (*In re* Walt Disney Co. Derivative Litig.) (*Disney VI*), 906 A.2d 27, 73–74 (Del. 2006) ("This claim is rooted in the doctrine that a plaintiff who fails to rebut the business judgment rule presumptions is not entitled to any remedy unless the transaction constitutes waste." (citing W. Point-Pepperell, Inc. v. J.P. Stevens & Co. (*In re* J.P. Stevens & Co. S'holders Litig.), 542 A.2d 770, 780 (Del. Ch. 1988))); Lewis v. Vogelstein, 699 A.2d 327, 335–36 (Del. Ch. 1997) (noting that the business judgment rule does not apply to acts of waste).

212. *Vogelstein*, 699 A.2d at 336.

213. *Id.*

214. *Id.*

> could conclude that the corporation has received adequate consideration." A claim of waste will arise only in the rare, "unconscionable case where directors irrationally squander or give away corporate assets."[215]

Based on this definition of waste, the Delaware Supreme Court affirmed the Delaware Chancery Court's rejection of the plaintiffs' allegation of waste even though Ovitz received a severance package of $140 million after working for Disney for only fourteen months.[216]

V. Clarifying the Liability Standards and Improving the Hurdles of Shareholder Derivative Litigation

As shown in Part III, the Delaware courts are applying new scrutiny to directors' assertions of the business judgment rule in pretrial motions and allowing more cases to survive pretrial motions. With this new scrutiny, the Delaware courts have effectively raised the requirements for directors to prevail on pretrial assertions of the business judgment rule defense. Moreover, the courts are necessarily giving less deference to directors' decisions. Despite this new scrutiny, the Delaware courts have not announced any new standard of review for the business judgment rule or any new standards for its underlying fiduciary duties.

As Part IV explained, the Delaware courts' decisions on the business judgment rule have created a significant disparity between the standards of conduct for directors' fiduciary duties and the standards of liability for alleged breaches of those duties. Based on this disparity, the Delaware courts can deny pretrial motions asserting the business judgment rule based on the standards of conduct, without referring to the much lower standards of liability for breaches of the fiduciary duties. The Delaware courts' decisions inject unnecessary doctrinal chaos and unpredictability into shareholder derivative litigation. This confusion and uncertainty has potential negative consequences for shareholders, corporations, directors, investors, and other litigants.

Following the Delaware courts' lead, shareholder-plaintiffs and their attorneys can draft complaints based upon the courts' statements of the strict fiduciary duties owed by directors and the courts' descriptions of conduct constituting best practices. Because Delaware case law contains language supporting causes of actions based on these standards of conduct, plaintiffs' attorneys may advise potential clients, without running afoul of ethical limitations, to pursue their claims under Delaware law. As a result,

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215. *Disney VI*, 906 A.2d at 74 (footnote omitted) (quoting Brehm v. Eisner (*Disney II*), 746 A.2d 244, 263 (Del. 2000)).

216. *Id.*

the number of derivative lawsuits may potentially increase as may the number of meritless lawsuits.

Even if plaintiffs' attorneys recognize the disconnect in Delaware law between the broadly stated fiduciary duties and the narrow analyses of alleged breaches of those duties in assessing the business judgment rule, the attorneys may also recognize the likelihood that such cases will survive pretrial motions given the recent trend in the Delaware courts. Thus, plaintiffs' attorneys may file derivative actions of questionable merit, hoping to survive a pretrial motion and to persuade the corporation to settle the action to avoid the expense of discovery and the risk of trial. Similarly, now that Delaware courts apply new scrutiny to assertions of the business judgment rule in pretrial motions (as shown in Part III), plaintiffs' attorneys may either misjudge the likelihood that their cases will ultimately succeed on the merits or overestimate the settlement value of their cases. These potential miscalculations create the risk that plaintiffs will file more shareholder derivative actions and that the settlement value of those actions will increase.[217]

The confusion and uncertainty in Delaware law also leaves Delaware corporations and their directors without guidance on how to act to receive the protection of the business judgment rule at the earliest stages of future litigation. Moreover, when Delaware courts increasingly allow derivative actions to survive pretrial motions, more cases will progress through discovery and trial, increasing attorneys' fees and expenses. Ultimately the corporation pays these expenses through insurance premiums or through indemnification agreements that typically require the corporation to pay the directors' expenses, attorneys' fees, judgments, fines, and settlement amounts.[218] Protracted litigation may also cause the corporation to bear other costs, such as distracted employees and directors, as well as negative publicity.[219]

This uncertainty potentially impacts directors' decision-making authority. Directors possess the statutory authority to govern the

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217. *Cf.* Bainbridge, *supra* note 40, at 101 (stating that a burden-shifting approach may increase a plaintiff's ability to survive a motion to dismiss and thus "the probability that more such actions will be brought and the settlement value of such actions increase").

218. *See, e.g.*, DEL. CODE ANN. tit. 8, § 145 (2008).

219. Joy v. North, 692 F.2d 880, 892 (2d Cir. 1982) (discussing judicial scrutiny of an SLC's recommendation to dismiss and noting that a court may consider the "time spent by corporate personnel preparing for and participating in the trial," the "distraction of key personnel by continued litigation," and the "potential lost profits which may result from the publicity of a trial"); *see also* Betsy Atkins, *The Board in Crisis*, *in* FIRST ANNUAL DIRECTORS' INSTITUTE ON CORPORATE GOVERNANCE 899, 901–02 (PLI Corp. Law & Practice, Course Handbook Series No. B0-021D, 2003), WL 1388 PLI/Corp 899 ("A negative news article or series of such articles could lead to a ratings downgrade, increasing funding costs or even eliminating the ability to access capital markets, which in turn could contribute to covenant defaults.").

corporations they serve.[220] By contrast, shareholders possess the right to approve certain actions proposed by directors (such as mergers) and have few means to hold directors accountable for their decisions.[221] The limited power of shareholders aligns with the statutory grant of decision-making authority to directors. If shareholders possessed more power to make decisions or to hold directors accountable for their decisions, then directors' authority would decrease because some of the directors' authority would be transferred to shareholders.[222] Likewise, if shareholders' ability to file and maintain derivative actions has increased, then directors' decision-making authority has likely decreased. An increased potential for derivative litigation may also lead directors to make "safe" decisions that will not produce litigation. As a consequence, directors might avoid taking calculated business risks that could increase shareholder wealth. Thus, all shareholders would be harmed.

A derivative action may also harm shareholders because all shareholders of a corporation ultimately bear the litigation expenses. While the shareholder-plaintiffs need to own only a minimal interest to bring a derivative action on behalf of the corporation,[223] the costs accrue to all the corporation's shareholders and not just the few shareholders who brought the lawsuit.[224] Thus, the shareholders who are not plaintiffs involuntarily bear the expenses of an unwanted lawsuit. Further, the litigation may reduce shareholder wealth because "[t]he litigation costs imposed on the firm may well exceed the damages awarded even in successful suits."[225] Empirical evidence also suggests that filing a derivative action triggers "significant negative stock price reactions,"[226]

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220. *See* DEL. CODE ANN. tit. 8, § 141(a) (2008).

221. Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547, 559 (2003).

222. *Id.* at 572–73.

223. Fischel & Bradley, *supra* note 10, at 271 ("Shareholders with tiny investments can bring derivative actions on behalf of a corporation.").

224. *Id.* (noting that shareholders who are not plaintiffs "ultimately bear the costs" of derivative actions); Jonathan R. Macey, *Courts and Corporations: A Comment on Coffee*, 89 COLUM. L. REV. 1692, 1701 n.36 (1989) ("[N]onplaintiff-shareholders . . . bear the costs of the litigation but enjoy only a fraction of the benefits . . . ."). Moreover, the shareholders bearing the costs of a fiduciary-duty breach and subsequent derivative litigation are not necessarily the shareholders benefiting when such litigation succeeds in recovering damages for the corporation. Only those shareholders owning shares at the time of the breach through the time of final judgment both bear the costs and enjoy the benefits of such litigation.

225. Fischel & Bradley, *supra* note 10, at 279 (noting that derivative actions based on public policy, such as environmental concerns, will "undoubtedly decrease the wealth of the firm's equityholders").

226. Stephen P. Ferris, Robert M. Lawless & Anil K. Makhija, *Derivative Lawsuits as a Corporate Governance Mechanism: Empirical Evidence on Board Changes Surrounding Filings* 33 (Univ. of Mo. Contracting & Orgs. Research Inst., Working Paper No. 2001-03, 2001), *available at* http://ssrn.com/abstract=495583.

which damage all shareholders.

Attorneys are the only clear winners from the confusion and unpredictability created by the Delaware courts. In fact, many plaintiffs' attorneys may be motivated solely by the attorneys' fees that derivative litigation generates.[227] Thus, while derivative actions can serve as a "material check on managerial behavior,"[228] the incentives for plaintiffs' attorneys to bring such actions cannot be ignored.[229] *Disney* is an example of plaintiffs' attorneys' selfish incentives to bring derivative actions.[230] After ten years of litigation, the shareholder-plaintiffs in *Disney* recovered nothing for the corporation and the other shareholders.[231] The lead plaintiffs' attorney in *Disney*, however, did not seem discouraged by the loss: "'We are disappointed that the court did not agree with our appeal, but nonetheless we believe that we have vindicated important principles of corporate governance.'"[232]

Further, if the confusion and unpredictability created by the Delaware courts promote the filing of more derivative actions and allow more actions to survive pretrial motions, then other litigants will suffer. The time devoted by the Delaware courts to derivative litigation as a result of their increased willingness to deny pretrial motions in such cases will result in considerable delay in resolving other cases. In addition, other state courts looking to Delaware corporate law lack guidance in evaluating the business judgment rule for the entities incorporated in these states.

Finally, the Delaware courts' recent decisions also risk undermining shareholder confidence in corporate stocks, just as the recent corporate scandals did.[233] Increased shareholder derivative suits could cause investors to lose confidence in director-managed corporations and lead investors not to invest in the stock market. Increased derivative litigation may also make directors more wary, leading them to vote for the "safe" course of action in an attempt to avoid litigation. If directors opt not to

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227. *See* Fischel & Bradley, *supra* note 10, at 271–72 ("If the action appears to be a positive net value project because of the possible recovery of attorneys' fees, an attorney will pursue it regardless of its effect on the value of the firm." (footnote omitted)).

228. *Id.* at 280–82 (analyzing the impact of derivative actions on the wealth of the corporation's shareholders).

229. *See id.* at 279.

230. Jonathan Macey, *Delaware: Home of the World's Most Expensive Raincoat*, 33 HOFSTRA L. REV. 1131, 1132 (2005) ("The Delaware judiciary has created an environment in which lawsuits are plentiful, legal fees are high, and attorneys' fees generously awarded, but where directors, in the end, are protected from liability by the slow and steady hand of the Delaware judiciary.").

231. *Id*. at 1131.

232. Richard Verrier, *Ruling on Ovitz's Severance Is Upheld; Delaware's High Court Finds that Disney's Board Did Not Betray Its Duty to Investors*, L.A. TIMES, June 9, 2006, at C1 (quoting Steven Schulman).

233. *See* Veasey, *supra* note 1, at 442 ("In the wake of Enron, Worldcom and other debacles, markets plunged, innocent people lost significant values in their retirement accounts, and investor confidence plummeted.").

take calculated business risks, corporate returns for shareholders could decline and again negatively affect investment in corporate stocks.

Although the Delaware courts ultimately found that the *Disney* defendants did not breach any fiduciary duty and that the business judgment rule protected their decisions, the opinions from the Delaware courts in *Disney*, and other recent cases, contain language that gives hope to future litigants and may even encourage lawyers to bring more derivative suits. In addition, by repeatedly reprimanding directors for failing to meet best practices in corporate governance, the *Disney* litigation might make directors more likely to seek legal advice to protect themselves from being castigated like the *Disney* directors.[234] As one commentator noted, the Delaware Chancery Court's opinion in *Disney* "is noteworthy because it manages to side with the defendants while simultaneously giving them significant incentives to cloak their decisions in a dense shroud of process and to take other steps that will generate high fees for lawyers, investment bankers, and other advisers."[235]

A common-law doctrine that best serves to create fees for attorneys and other corporate consultants is a doctrine in desperate need of an overhaul. Two primary improvements should be implemented by either the courts or the legislature. First, clear standards of legal liability must be stated. Second, procedural requirements for shareholder derivative actions should be implemented to deter meritless lawsuits and to assess the business judgment rule early in litigation.

A. *Implementing Clear Standards of Legal Liability*

The fiduciary duties constitute standards of conduct that guide directors in carrying out their roles.[236] The business judgment rule, on the other hand, "states the test a court should apply when it reviews [directors'] conduct to determine whether to impose liability."[237] As explained in Part IV, current Delaware case law broadly defines corporate standards of conduct for directors, while imposing much lower standards of liability when assessing alleged breaches of directors' fiduciary duties.[238] Unlike many areas of law where the standard of conduct and the standard of liability are the same, in corporate law these standards diverge, and the

234. *See* Macey, *supra* note 230, at 1137 ("Moreover, there is the tone of the opinion, in which the directors are repeatedly chastised for failing to live up to best practices as they apply to corporate governance issues. It will be worth a lot of professional fees to directors to avoid being pilloried the way that the directors and top officers of Disney were pilloried in this opinion.").

235. *Id.*

236. MELVIN ARON EISENBERG, CORPORATIONS AND OTHER BUSINESS ORGANIZATIONS 401 (concise 9th ed. 2005) ("A standard of conduct states how an actor should conduct a given activity or play a given role." (emphasis omitted)).

237. *Id.*

238. *Id.* at 401–02.

Delaware courts have exploited this divergence in recent opinions as demonstrated in Part III.[239] To counter this disconnect in Delaware law, the standards of liability and the standards of conduct should be aligned. This result could be accomplished in two ways. The standards of liability could be raised to match the current standards of conduct. Alternatively, the current standards of conduct could simply be deleted.

If courts or legislatures make a normative determination that directors must be held to the broadly stated fiduciary duties, then liability should be based upon violations of those standards of conduct. Proponents of this higher standard of liability may argue that the standard gives directors the proper incentives to act in the best interests of the corporation and its shareholders. However, raising the standards of liability potentially presents significant risks for shareholders because directors may avoid taking justified business risks for fear of legal liability, which could decrease the investment returns for shareholders. Similarly, the fear of liability may dissuade individuals from becoming directors or continuing as directors, which may also negatively impact corporate governance. Holding directors to a higher standard of legal liability may also produce more lawsuits. Thus, increasing the standard of legal liability will likely harm, more than help, shareholders in the long run.

A better alternative recognizes the sufficiency of the current standards of legal liability and eliminates any language regarding standards of conduct or best practices. Critics of this approach may argue that directors will not exercise the standards of conduct and best practices that shareholders expect. However, legal liability cannot be imposed every time hindsight makes clear that a board did not follow best practices. That would be like holding Toyota liable for not making each of its vehicles to the standards of its high-end Lexus vehicles. The concept of "best" practices, by its very nature, constantly evolves, and both directors and courts will struggle to compare actual corporate conduct to this ever-changing concept. More importantly, the courts are neither the only, nor arguably the best, institution to provide normative standards of conduct for directors. In fact, the NYSE, corporate industry groups, and even institutional investors already supply normative standards of conduct and best practices.[240]

Furthermore, shareholders possess other methods for ensuring that directors make decisions in the best interests of shareholders. If

239. *See id.* at 401.

240. *See, e.g.*, NYSE, Inc., *supra* note 182, § 303A (providing the NYSE Corporate Governance Rules); BUS. ROUNDTABLE, PRINCIPLES OF CORPORATE GOVERNANCE (2005), *available at* http://www.businessroundtable.org/pdf/CorporateGovPrinciples.pdf; CAL. PUB. EMPLOYEES' RET. SYS., CORE PRINCIPLES OF ACCOUNTABLE CORPORATE GOVERNANCE (2007), *available at* http://www.calpers-governance.org/principles/domestic/us/downloads/us-corpgov-principles.pdf.

shareholders of a public corporation believe that directors failed to use best practices in making decisions, then those shareholders may readily sell their shares. Further, after a breach of fiduciary duty is discovered, shareholders may remove the errant director from office or decline to re-elect the director at the next annual meeting.[241] Shareholders may also propose courses of action for the board of directors and thereby influence directors' decisions.[242] A variety of markets—including "capital and product markets, the internal and external employment markets, and the market for corporate control"—hold directors accountable.[243] In addition, directors' conduct may be constrained by their interest in maintaining their reputations[244] and by their fellow directors.[245] Admittedly, these enforcement mechanisms do not provide a perfect solution to the agency problem presented in corporations where management and ownership are separate, and where necessary information may be unknown to shareholders. And some of the mechanisms may not apply to closely held corporations. Yet the severe costs to shareholders from imposing a higher standard of legal liability are not ideal either.

These proposals for reform will guide corporations and their directors on how to conduct themselves to obtain the protection of the business judgment rule and on how to do so early in litigation. More importantly, a clear standard of liability allows shareholder-plaintiffs and their attorneys to evaluate more accurately the likelihood of success for derivative litigation and to know what they must prove to prevail on their claims. Either the Delaware Supreme Court or the Delaware Legislature

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241. *See, e.g.*, DEL. CODE ANN. tit. 8, § 141(k) (2008); MODEL BUS. CORP. ACT §§ 8.08–8.09 (2007). The true power of shareholders to nominate and elect directors is the subject of much debate among scholars. *See, e.g.*, Lucian A. Bebchuk, *The Myth of the Shareholder Franchise*, 93 VA. L. REV. 675, 677 (2007) (proposing corporate law amendments "to transform shareholder power to remove directors from a myth into a reality," such as "shareholder access to the corporate ballot," "reimbursement of expenses to challengers receiving a sufficiently significant number of votes," "shareholder power to replace all directors," and "confidential voting and majority voting"); Stephen M. Bainbridge, *The Case for Limited Shareholder Voting Rights*, 53 UCLA L. REV. 601, 602–03 (2006) (arguing that efforts to expand the shareholder franchise are misguided).

242. *See* 17 C.F.R. § 240.14a-8 (2008).

243. Bainbridge, *supra* note 40, at 122. *But see* Fairfax, *supra* note 8, at 429–30 (noting that the market failed to regulate directors at Enron and WorldCom); *id.* at 448 ("[T]he market may provide a strong incentive to corporate directors to publish overly optimistic news while ignoring red flags and failing to scrutinize officer conduct.").

244. John C. Coffee, Jr., *Understanding the Plaintiff's Attorney: The Implications of Economic Theory for Private Enforcement of Law Through Class and Derivative Actions*, 86 COLUM. L. REV. 669, 718 (1986) (noting that directors' fear of damaged reputations from shareholder derivative litigation constrains their behavior).

245. *Cf.* Bainbridge, *supra* note 40, at 125–26 (noting that a board of directors is an example of a "relational team" and that such teams "are best monitored by a combination of mutual motivation, peer pressure, and internal monitoring").

could implement the standards of liability.

The Delaware Supreme Court could wipe the slate clean and provide clear standards of legal liability in a continuing evolution of the common law. However, given that the Delaware Supreme Court created the existing confusion and unpredictability, the court is unlikely to provide a global clarification of the law. Such standards could more easily be codified by the Delaware Legislature.[246] The legislature might enact such a statute if persuaded that the statute would protect corporate directors,[247] just as it was persuaded to enact § 102(b)(7) to mitigate *Van Gorkom*'s impact on directors.[248]

Critics of a statutory response may argue that flexibility will be lost because statutory law cannot respond to future changes in corporations.[249] Although called a rule, the business judgment rule actually forms a standard and not a rule.[250] Unlike a rule, a standard has flexibility. Thus, even if a statute provides the new standard,[251] the courts will apply that

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246. *See* Joan MacLeod Heminway, *Rock, Paper, Scissors: Choosing the Right Vehicle for Federal Corporate Governance Initiatives*, 10 FORDHAM J. CORP. & FIN. L. 225, 262–71 (2005).

247. For example, the American Law Institute (ALI) has codified a version of the business judgment rule. The ALI's version states:

> (c) A director or officer who makes a business judgment in good faith fulfills the duty [of care] . . . if the director or officer:
>
> (1) is not interested . . . in the subject of the business judgment;
>
> (2) is informed with respect to the subject of the business judgment to the extent the director or officer reasonably believes to be appropriate under the circumstances; and
>
> (3) rationally believes that the business judgment is in the best interests of the corporation.

1 PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 54, § 4.01(c). The main distinction between the ALI approach and the Delaware presumption is that the ALI version places the burden on the directors to establish the presence of the rule's elements, and if the directors do so then they enter a safe harbor. *See* Branson, *supra* note 46, at 635.

248. *See supra* note 148 and accompanying text.

249. Costa, *supra* note 55, at 46 (noting that Delaware Chancery Court Judge Strine "has warned against the ill effects of 'bright line rules,' which can lead to policies that are 'too rigid and punitive, and that cannot respond flexibly to future developments'"); *id.* at 47 ("When it comes to corporation law, a significant common law component is inescapable: A statute can't capture the innovation and variety that defines business activity.").

250. Bainbridge, *supra* note 40, at 128 ("[T]he business judgment rule clearly is misnamed; it is a standard, not a rule."); Branson, *supra* note 46, at 631 (noting that the business judgment rule "has no mandatory content[,] . . . . involves no substantive 'do's' or 'don'ts' for corporate directors or officers," and "entail[s] only slight review of business decisions").

251. *Compare* Costa, *supra* note 55, at 46 ("[I]nconsistencies in the state's corporate common law can be a source of dynamism. They enable judges to update the law slowly and methodically as new facts present themselves, taking account of innovations in business and new understandings

standard to the facts of each case and thereby will maintain the standard's flexibility.[252] Indeed, the Model Business Corporation Act, which enumerates standards of conduct and standards of liability for directors, offers a partial statutory codification.[253]

To state a clear standard for the business judgment rule, the methods for rebutting that defense must also be defined with a litigation perspective. Fraud, illegality, and waste already supply standards of liability, but the fiduciary duties do not. Like the business judgment rule, the fiduciary duties are standards, not rules. Although the fiduciary duties can never be defined with absolute precision for every situation in every corporation, the following subsections outline the parameters of the standards of liability for the duties of care, loyalty, and good faith.

1. The Duty of Care

A due-care analysis that allows a merit-based review presents an obvious opportunity for shareholders and courts to second-guess directors' decisions with the benefit of hindsight. Current common law allowing courts to review directors' decisions for "rationality" or "irrationality" presents that risk because such a determination necessarily involves reviewing the substance of the directors' decision. No consistent boundaries can be developed for reviewing the substance of directors' decisions in litigation. In addition, if shareholders can second-guess directors' decisions through litigation, then the authority to manage the corporation has shifted from directors to shareholders and courts.[254] Further, allowing a substantive review of directors' decisions almost guarantees that courts will find that a factual question exists about whether a director breached the duty of care. After finding a factual question, a court cannot grant a motion to dismiss or a motion for summary judgment.

Reviewing the procedures that directors followed in making a challenged decision, however, permits an objective method of review.[255]

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about how incentives affect behavior."), *with id.* at 47 ("In the hands of a wayward judge, poorly articulated equitable principles or dramatic shifts in doctrine could also create confusing and ever-changing legal guardrails. And since it's the managers who choose where to incorporate, Delaware, the leading venue, has an incentive to play to their interests at the expense of shareholders.").

252. *See* Bainbridge, *supra* note 40, at 128 ("The greater flexibility inherent in standards frequently comes into play in business judgment rule jurisprudence as courts fine tune the doctrine's application to the facts at bar.").

253. MODEL BUS. CORP. ACT §§ 8.30–8.31 (2007) (codifying the fiduciary duties but not the business judgment rule); *id.* § 8.30 official cmt. at 8-189 ("Section 8.30 does not try to codify the business judgment rule or to delineate the differences between that defensive rule and the section's standards of director conduct. Section 8.30 deals only with standards of conduct—the level of performance expected of every director . . . .").

254. *See* Bainbridge, *supra* note 40, at 108.

255. Branson, *supra* note 46, at 640.

This process-oriented approach prevents courts and shareholders from second-guessing the merits of directors' decisions with the benefit of hindsight and maintains directors' authority to make decisions for the corporation so long as they do so with care. Yet this approach also allows shareholders and courts to review the process that the directors used to make decisions. A process-oriented approach would reach the potential duty-of-care breaches in the recent scandals, which revealed that "many boards of directors are captured by the firm's senior management and simply rubberstamp management decisions."[256] Enron's board of directors provides a prime example of directors failing to adequately inform themselves and to monitor management.

> [S]ome directors have admitted to signing off on company reports with limited or no knowledge of their contents, while others have admitted to approving transactions even when they did not fully understand them. Still other directors made decisions regarding highly complex transactions after only brief consideration of the issues critical to those transactions. These actions appear contrary to the directors' duty to remain informed and suggest that instead of providing a vigorous check on managerial conduct, the directors merely rubber-stamped management's decisions. Then too, despite their awareness of potential risk, directors only made cursory inquiries into transactions involving conflicts of interest or high-risk hedge activity. Again, such conduct seems inconsistent with the directors' fiduciary obligation to ask probing questions before approving company transactions.[257]

Thus, Enron demonstrates that courts can protect shareholder interests without reviewing the substance of directors' decisions.

If directors use the process-oriented approach in making decisions on behalf of the corporation, they can assure themselves that potential plaintiffs will file few lawsuits alleging violations of the duty of care. The minutes of the board of directors can contain sufficient evidence that the

256. Bainbridge, *supra* note 40, at 105; *accord* Fairfax, *supra* note 8, at 399 (stating that Enron's directors "merely rubber-stamped management's decisions"); *see* BAINBRIDGE, *supra* note 25, § 5.3, at 205–06 (discussing management-captured boards and the protections against them, such as more focus on process and oversight).

257. Fairfax, *supra* note 8, at 399 (footnotes omitted); SKEEL, *supra* note 7, at 163 ("[T]here was precious little evidence that the directors paid much attention as the tide turned at each of these companies. . . . Nor do any of the directors seem to have asked any serious questions about Enron's increasingly grandiose plans to create markets in everything under the sun.").

directors gathered all information reasonably available to them and reasonably deliberated before making a decision.[258] Thus, the minutes should reflect how the directors informed themselves—by documenting whether the directors received information before the meeting, whether officers or outside experts made presentations to the board, and whether any questions were raised.[259] The directors can then attach to the minutes the distributed documents and presentations, and can also document the time spent discussing each issue.[260] By placing these details in the meeting minutes, the directors will have the evidence necessary to defeat any allegation that they breached their duty of care, and more importantly, they will have actually taken due care in making their decisions.[261] In addition, such evidence should allow the directors to prevail on an early motion to dismiss.

A potential criticism of such detailed minutes is that corporations may jump through the necessary procedural hoops but would avoid any substantive action required by their fiduciary duties. Notwithstanding this criticism, courts cannot define, let alone evaluate, the substance of directors' decisions without interfering with directors' statutory authority to manage the corporation. Further, plaintiffs have recourse in instances where corporations falsely document their procedures.[262]

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258. *See* Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985); *see also* Richard M. Cieri & Michael J. Riela, *Protecting Directors and Officers of Corporations That Are Insolvent or in the Zone or Vicinity of Insolvency: Important Considerations, Practical Solutions*, 2 DEPAUL BUS. & COM. L.J. 295, 317 (2004) ("The Walt Disney case illustrates the importance of keeping adequately detailed minutes of committee and board meetings . . . . [B]ecause the minutes of the committee and board meetings were so sparse the court drew an inference that the directors did not exercise their duty of care.").

259. *Cf.* Donald J. Wolfe et al., *Notable Delaware Corporate Decisions 2005: Delaware-Centric Musings on Disney, Toys "R" Us, TCI, Unisuper, and Examen*, *in* WHAT ALL BUSINESS LAWYERS AND LITIGATORS MUST KNOW ABOUT DELAWARE LAW DEVELOPMENTS 2006, at 441, 450 (PLI Corp. Law & Practice, Course Handbook Series No. 8423, 2006), WL 1543 PLI/Corp 441 (noting that formal meetings matter because they provide a sufficient "record to establish that proper deliberation and care with respect to a matter occurred").

260. *Cf. id.* at 451 ("[B]oard meeting minutes should be detailed enough that it is later possible for the board to establish, or a neutral fact finder to determine, the approximate length of time spent considering a matter of importance and the general nature of the matters discussed.").

261. *See* Atkins, *supra* note 219, at 907 ("Having adequate meetings, well-documented minutes showing careful deliberations, and thorough briefings demonstrate a decision 'process' discharging their duty of care, which helps immunize the board from future lawsuits.").

262. *See* FED. R. EVID. 902(11)(C) (stating that a party must provide written notice of an intention to offer business records into evidence and "must make the record and declaration available for inspection sufficiently in advance of their offer into evidence to provide an adverse party with a fair opportunity to challenge them"); DEL. UNIF. R. EVID. 902(11)(C) (same); *see also* Lano v. Rochester Germicide Co., 113 N.W.2d 460, 464 (Minn. 1962) (stating that corporate minutes are only prima facie records of the proceedings and oral testimony is admissible to show the minutes are incomplete), *overruled on other grounds by* Melin v. Nw. Bell Tel. Co., 266 N.W.2d 183 (Minn. 1978); Plumbers & Steamfitters, Local Union 530 Annuity Fund v. Shaffer,

Upon review in litigation, courts can capably assess the procedures that directors followed in making a decision by examining whether the directors gathered all information reasonably available to them. The standard of liability thus would state that directors have a duty to inform themselves of all reasonably available information before making a decision, and the court would impose liability when directors violated that standard. Although Delaware courts have sometimes required plaintiffs to prove the directors' violation of due care amounted to gross negligence,[263] a properly defined standard of liability negates the need for showing gross negligence.[264]

2. The Duty of Loyalty

The standard of liability for the duty of loyalty should state that directors must be disinterested and independent to make a decision in the best interests of the corporation and its shareholders. Thus, if directors are self-interested in a transaction, courts may presume that those directors acted in their own interest and not in the best interests of the corporation when voting on the transaction. To avoid litigation, the interested directors must (1) disclose fully such interest to the other directors and (2) refrain from voting on the transaction.[265] Proving that a director has a direct financial interest in a transaction poses no significant problems in litigation. Further, through appropriate board minutes, directors can demonstrate that they disclosed any self-interest and refrained from voting on the transaction.

Beyond self-interest, however, the water becomes murky. Courts have assumed that a director with a close familial interest in a transaction cannot act independently.[266] Such family relationships have been confined primarily to immediate family—spouse, parents, siblings, and children.[267] In a litigation context, plaintiffs can easily identify and prove such relationships. However, the recent corporate scandals demonstrate that various types of friendships may affect a director's independence.[268] Unfortunately, friendship poses a problem as a basis for challenging the independence of directors. Both business and social relationships may be defined as friendships, and whether such relationships provide sufficient

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457 F. Supp. 954, 956 (W.D. Pa. 1978) (noting that, because minutes are only prima facie evidence of a meeting, parol evidence is admissible to prove errors in the minutes).

263. *Van Gorkom*, 488 A.2d at 873.

264. Bainbridge, *supra* note 40, at 128 ("No matter how gingerly courts apply the standard of liability, trying to measure the 'quantity' of negligence is a task best left untried.").

265. *See, e.g.*, DEL. CODE ANN. tit. 8, § 144(a) (2008).

266. *See* Telxon Corp. v. Meyerson, 802 A.2d 257, 264 (Del. 2002).

267. *See, e.g.*, NYSE, Inc., *supra* note 182, § 303A.02(b) cmt. (defining immediate family for the purpose of testing director independence).

268. *See supra* notes 172–73 and accompanying text.

reason to conclude that a director did not act independently presents a question of fact. Plaintiffs may identify directors as friends even when those directors do not consider themselves friends or anything more than colleagues. Moreover, a plaintiff will have difficulty proving that a friendship caused a director not to act independently because a director's subjective relationship presents an inherently factual issue. In addition, inquiring into the subjective relationship between directors presents a significant risk that plaintiffs and courts will evaluate the alleged friendship based on the merits of the transaction. For these reasons, independence should be limited to close familial relationships.

3. The Duty of Good Faith

Delaware has not clearly signaled whether a breach of the duty of good faith may ever serve as a basis for overcoming the business judgment rule presumption. To the extent that the duty of good faith already exists within the duty of loyalty,[269] a separate duty of good faith is not necessary. Similarly, to the extent that a court could hold that the same conduct violated both the duty of good faith and either the duty of loyalty or care, then a duty of good faith is unnecessary. In *Disney* and *Stone v. Ritter*, however, the Delaware courts signaled that good faith may occupy a sphere separate from care and loyalty by defining instances constituting bad faith.[270] Nonetheless, the courts did not clearly indicate whether "not in good faith" and "bad faith" are interchangeable.[271]

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269. *See* Stone v. Ritter, 911 A.2d 362, 370 (Del. 2006); *see also* Sale, *supra* note 189, at 463.

270. *See Stone*, 911 A.2d at 369; Brehm v. Eisner (*In re* Walt Disney Co. Derivative Litig.) (*Disney VI*), 906 A.2d 27, 52–53 (Del. 2006).

271. Elizabeth Nowicki, *Not in Good Faith Means Not in Good Faith*, CONGLOMERATE BLOG: BUS. L. ECON. & SOC'Y, Jan. 26, 2006, http://www.theconglomerate.org/2006/01/ not_in_good_fai.html.

> "[B]ad faith" and "not in good faith" mean two different things. By obligating a plaintiff to prove that a director acted in *bad faith*, the court is obligating the plaintiff to identify facts much *worse* than those that would establish *the lack of good faith*. That is to say, "bad faith" conduct is roughly conduct that is affirmatively against the interests of the corporation (such as fraudulent conduct). Good faith conduct is conduct that is in the best interest of and taken for the purpose of benefiting the corporation. So "not in good faith" conduct is conduct that is not taken for the purpose of benefiting the corporation—conduct that is not deliberately chosen as being in the best interest of the corporation. An act "not in good faith" does not have to be a nasty, fraudulent, selfish, etc. act. The phrase "not in good faith" does include these "bad faith" acts, but the phrase also includes acts that are not venal or otherwise ill-motivated, such as an abdication of duties due to time pressure.

Id.

But incorporating any duty of good faith into the business judgment rule engulfs the courts in an endless web. The primary problem with allowing a duty of good faith to overcome the business judgment rule presumption is that such allegations are inherently fact-based and thus rarely, if ever, could be resolved on pretrial motions. Any plaintiff's attorney could craft a complaint stating a claim for breach of the duty of good faith sufficient to survive a motion to dismiss.[272] Such an attorney could also likely gather the facts necessary to raise a factual dispute that could survive summary judgment. Thus, the case would get to trial on the issue of the directors' good faith. If a plaintiff alleging a breach of the duty of good faith can get to trial, then the litigation costs to the corporation and the nonplaintiff-shareholders increase, as does the amount of any potential settlement. Good faith thus may become the stalking horse of the plaintiffs' bar—the way to get a case to discovery and to trial.

The duty of good faith also provides a potential "catch all" for courts, particularly when a court cannot find a clear violation of the traditional duties of care or loyalty. Although good faith is a common concept in the law, few satisfying definitions exist. Courts and commentators have consistently struggled not only to define good faith in other contexts but also to define breaches of good faith. In fact, commentators have proposed abolishing good-faith standards in other areas of the law.[273] Moreover, courts have difficulty applying the concept of good faith with any consistency. For all these reasons, a duty of good faith should never serve as an independent basis for rebutting the presumption of the business judgment rule.

B. *Implementing Procedural Changes*

The unpredictability of shareholder derivative litigation could also be improved through several procedural changes. Enacting a heightened pleading standard, such as the one that exists for fraud claims, would provide a procedural change to deter frivolous and meritless derivative actions.[274] Shareholder derivative litigation already has a heightened

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272. A motion to dismiss for failure to state a claim may be granted "only if plaintiffs cannot prevail as a matter of law given all the reasonable inferences that could be drawn from the complaint." Krasner v. Moffett, 826 A.2d 277, 287 (Del. 2003).

273. *See, e.g.*, Ulrich Boettger, *Efficiency Versus Party Empowerment—Against a Good-Faith Requirement in Mandatory Mediations*, 23 REV. LITIG. 1 (2004) (arguing against imposing a good-faith requirement in mediations); Teri J. Dobbins, *Losing Faith: Extracting the Implied Covenant of Good Faith from (Some) Contracts*, 84 OR. L. REV. 227 (2005) (arguing that the covenant of good faith should not be implied in every contract); Rebecca Ellen Bruck, Comment, *Lessons in Eliminating Statutory Vagueness: Rule 11 of the FRCP as a Model for Removing the "Good Faith" Fulcrum from Section 707(a) of the Bankruptcy Code*, 19 BANKR. DEV. J. 399 (2003) (advocating for the elimination of the good-faith requirement in Chapter 7 bankruptcy proceedings).

274. *See* FED. R. CIV. P. 9(b).

pleading standard regarding the demand requirement, which permits motions to dismiss early in litigation.[275] Yet the hurdle imposed on shareholders by this demand requirement is low enough for many cases to survive it. The heightened pleading standard could be expanded to require shareholders to plead facts that overcome the business judgment rule presumption for the challenged board decision. In other words, shareholders would have to plead with specificity the factual allegations establishing a breach of one or more of the fiduciary duties, or establishing that the business judgment rule otherwise does not apply because of fraud, illegality, or waste. By requiring a heightened pleading standard, defendants could file motions to dismiss on the business judgment rule before discovery.

Under the current burden-shifting scheme, the business judgment rule establishes a hurdle that shareholders must overcome. Thus, the heightened pleading standard does not impose a new burden on shareholder derivative litigation. This standard would require, however, that shareholders and their attorneys do their homework before filing such suits. Shareholders can gather facts showing a breach of fiduciary duty by obtaining copies of the minutes of board of directors' meetings.[276] The minutes would reveal facts for a prima facie case of a duty-of-care breach. An investigation could also reveal any violations of the duty of loyalty, such as relationships among directors suggesting a lack of independence or a director being interested in the challenged transaction. The courts should not serve as the means by which shareholders can harass directors or conduct a fishing expedition.[277]

For many years, both the Federal Rule of Civil Procedure 23.1 and the Delaware Chancery Court Rule 23.1 have required the plaintiff in a derivative complaint to allege that the plaintiff was a shareholder at the time of the challenged transaction and to state the details of the demand requirement. The Delaware Chancery Court recently amended Rule 23.1 to deter frivolous derivative litigation by also requiring the plaintiff to file

> an affidavit stating that the person has not received, been promised or offered and will not accept any form of compensation, directly or indirectly, for prosecuting or serving as a representative party in the derivative action in which the person or entity is a named party except (i) such fees, costs or other payments as the Court expressly approves

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275. *See supra* Part II.A.

276. *See, e.g.*, DEL. CODE ANN. tit. 8, § 220(b) (2008); MODEL BUS. CORP. ACT § 16.02 (2007).

277. A Court may restrict a plaintiff's initial discovery when the court has reservations about the basis for the plaintiff's claims. *See In re* BHC Commc'ns, Inc. S'holder Litig., 789 A.2d 1, 14 (Del. Ch. 2001) (limiting topics and types of discovery).

> to be paid to or on behalf of such person, or (ii) reimbursement, paid by such person's attorneys, of actual and reasonable out-of-pocket expenditures incurred directly in connection with the prosecution of the action.[278]

This amendment, however, does not go far enough. The required affidavit may deter collusion between shareholder-plaintiffs and plaintiffs' attorneys, but the affidavit does nothing to ensure that shareholder-plaintiffs adequately represent all shareholders.

To ensure that plaintiffs adequately represent the corporation and all shareholders, the Delaware Legislature could further amend Delaware Chancery Court Rule 23.1 to require that shareholders representing a specified percentage of ownership join together as plaintiffs to bring a derivative action. The specified percentage of ownership could be measured in dollars or percentage terms. For instance, the amendment could require that the plaintiffs collectively own $5,000 or 5% of a corporation's outstanding stock. Increasing the financial stake of the plaintiffs in the litigation will increase the likelihood that those plaintiffs act in the best interests of the corporation and all its shareholders because the plaintiffs stand to lose more in unsuccessful litigation. The required percentage must not be set so high as to prevent all such actions but must be set high enough to ensure that the challenged director conduct concerns all shareholders.

In conjunction with this percentage requirement, or as an alternative, Delaware could enact a statute requiring plaintiffs to post security for expenses (i.e., a bond) as a prerequisite to filing a shareholder derivative action unless they collectively meet the prescribed percentage of ownership. This requirement would help ensure that plaintiffs adequately represent all shareholders by demanding a significant monetary investment in the litigation. Several states have adopted similar statutes,[279] which typically require plaintiffs filing derivative actions to post a bond in an amount sufficient to cover the defendants' reasonable attorneys' fees and expenses.[280]

Other procedural changes could assess the business judgment rule early in litigation to weed out meritless lawsuits before discovery. Plaintiffs' attorneys may argue that any ruling on the business judgment rule should come at the close of discovery because otherwise no shareholder could

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278. DEL. CH. CT. R. 23.1(b) (effective Jan. 1, 2007).

279. 7C CHARLES ALAN WRIGHT ET AL., FEDERAL PRACTICE AND PROCEDURE § 1835, at 164 n.1 (3d ed. 2007) (listing Arizona, California, Colorado, Florida, Nebraska, New Jersey, New York, Pennsylvania, and Wisconsin as states adopting such bond requirements).

280. *See, e.g.*, COLO. REV. STAT. § 7-107-402(3) (2007) (allowing a court to compel a shareholder who owns less than a prescribed amount of stock to post a bond); N.Y. BUS. CORP. LAW § 627 (McKinney 2008) (same).

gather evidence to overcome the defense. In allowing discovery, however, the corporation and the directors must spend significant amounts of time and resources on the litigation. If the court can make a preliminary decision on the likelihood of the plaintiffs prevailing on the merits—rebutting the business judgment rule—then that decision would save time and resources to the benefit of all.

The obvious question is how such a decision could be made. A motion to dismiss is one possibility, but courts can manipulate these motions and frustrate the purposes of the business judgment rule. Further, a decision denying a motion to dismiss is generally not immediately appealable.[281] An alternative would be to treat the business judgment rule similar to the absolute-immunity and qualified-immunity defenses.[282] A decision on immunity occurs early in the litigation because a later decision destroys the benefit of immunity.[283] An order denying immunity is also immediately appealable[284] because the benefit of immunity is destroyed if the defendant must litigate to a final judgment before appealing the immunity issue. Similarly, the rationale and purpose of the business judgment rule suggests that courts should decide the applicability of the defense early in litigation to provide proper deference to directors' statutory authority to manage the corporation and to protect the non-plaintiff shareholders. Also, the possibility of an immediate appeal will help ensure that trial courts properly analyze the relevant standards of liability and that they do not frustrate the purposes of the business judgment rule.

VI. CONCLUSION

In response to recent corporate scandals, the Delaware courts unnecessarily injected doctrinal confusion and unpredictability into shareholder derivative litigation. The courts are allowing more cases to survive pretrial motions asserting the business judgment rule defense without stating any new standards. Instead, the courts are exploiting the disparity they previously created between the standards of conduct for directors' fiduciary duties and the standards of liability applied for assessing alleged breaches of those duties. As a result, Delaware law potentially creates significant negative consequences for shareholders, corporations, directors, investors, and other litigants.

The Delaware Legislature could remove this doctrinal confusion and unpredictability by enacting a statute that codifies the business judgment

281. Lauro Lines s.r.l. v. Chasser, 490 U.S. 495, 497–98 (1989).

282. *See* Ann M. Scarlett, *A Better Approach for Balancing Authority and Accountability in Shareholder Derivative Litigation*, 57 U. KAN. L. REV. __ (forthcoming 2008) (addressing this proposal and the broader issue of providing proper deference to directors' decisions).

283. Mitchell v. Forsyth, 472 U.S. 511, 525 (1985).

284. *Lauro Lines*, 490 U.S. at 499–500.

rule and defines clear standards of liability for the rule's underlying fiduciary duties. The courts would continue to play a key role in regulating the conduct of corporate directors by applying those standards to the cases that the court is called upon to decide, but the courts would need to exercise caution to retain clear standards of legal liability by which directors may govern their behavior and shareholders may evaluate potential derivative cases. In addition, procedural changes could be implemented to deter frivolous derivative cases and to weed out meritless cases early in litigation. With these changes, shareholder derivative litigation can continue to play its proper role in corporate governance.