Director Compliance with Elusive Fiduciary Duties in a Climate of Corporate Governance Reform

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Director Compliance with Elusive Fiduciary Duties in a Climate of Corporate Governance Reform

Nadelle Grossman*
ARTICLES

DIRECTOR COMPLIANCE
WITH ELUSIVE FIDUCIARY DUTIES IN A
CLIMATE OF CORPORATE GOVERNANCE REFORM

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TABLE OF CONTENTS

I.  INTRODUCTION ........................................................................... 395

II.  TRADITIONAL NOTIONS OF FIDUCIARY DUTIES ......................... 400
    A. Duty of Care ......................................................................... 402
    B. Duty of Loyalty ..................................................................... 407
    C. Duty of Candor/Disclosure ................................................... 408
    D. Duty of Good Faith ............................................................... 409
    E. Demand Futility and the Special Litigation Committee .......... 410

III. FEDERAL SECURITIES LAWS AND SRO LISTING STANDARDS
    AS SOURCES OF CORPORATE GOVERNANCE ............................... 412
    A. Historic Role of Securities Laws and SRO Listing
       Standards ............................................................................. 412
    B. The Enactment of SOX and SRO Corporate Governance
       Listing Standards .................................................................... 414
    C. Provisions of SOX and SRO Rules Affecting Corporate
       Governance ........................................................................... 418
    D. SOX and SRO Rules Step into the Ring with Fiduciary
       Duties ................................................................................... 428

IV. DELAWARE FIDUCIARY DUTIES TAKE CENTER STAGE,
    AGAINST THE BACKDROP OF THE REFORM ................................. 430
    A. The Duties of Care and Good Faith Revisited Post-
       Reform .................................................................................. 431
    B. Director Independence Post-Reform ....................................... 446
    C. Duty of Candor/Disclosure Post-Reform ................................. 457
    D. Are We There Yet? ............................................................... 458

V.  HOW DOES A DIRECTOR DISCHARGE HER EVER-ELUSIVE
    FIDUCIARY DUTIES? .................................................................. 460

VI. CONCLUSION .............................................................................. 465
I. INTRODUCTION

In the wake of accounting abuses at Enron, WorldCom, Adelphia, Qwest, Global Crossing and Tyco, to name a few, “corporate governance” has become a household phrase. These massive corporate scandals cast a bright, public spotlight on the failures of directors to act as the eyes and ears of stockholders who elected them. Yet the very role of a board of directors in the system of corporate governance is to oversee a corporation’s business and affairs, including its management, because numerous dispersed stockholders cannot effectively perform that function on their own. Thus when management fraud and misconduct burgeon, it is presumed that the public is justified in pointing a finger at directors for having inadequately supervised management.

But if directors incurred liability for every misstep they took, or bad decision they made, it would indeed be rare to find a person willing to


And it is a clear failure of corporate responsibility when outside directors, auditors and lawyers, who have important roles in our system of independent checks on the corporation’s management, fail to avert or even discover—and sometimes actually condone or contribute toward the creation of—the grossest of financial manipulations and fraud.

Id.; Marianne M. Jennings, Symposium on Ethics in Corporate Governance: Restoring Ethical Gumption in the Corporation: A Federalist Paper on Corporate Governance—Restoration of Active Virtue in the Corporate Structure to Curb the “YeeHaw Culture” in Organizations, 3 WYO. L. REV. 387, 402-05, 441-44, 475-78 (2003) (referring to the Enron board as a board full of conflicts of interest and fulfilling a rubber-stamp function, the WorldCom board as dominated by the CEO and “not a particularly curious board” and the Tyco board as “far too unquestioning” of the CEO and dominated by current and former Tyco employees).

serve as a director. The balance between holding directors accountable for their failures, yet encouraging them to serve and make risky and potentially value-creating business decisions, is delicate. Corporate governance, the framework that defines the relationship between a corporation and its officers, directors and stockholders, determines this balance by setting standards for director conduct and liability.

The framework for corporate governance is derived primarily from state law. Under the internal affairs doctrine, the laws of the state of incorporation govern the internal affairs of corporations incorporated therein. To maintain board accountability in the corporate governance framework, directors owe fiduciary duties to the stockholders who elect them. In Delaware, where the majority of U.S. corporations are

3. See William T. Allen et al., Function Over Form: A Reassessment of Standards of Review in Delaware Corporation Law, 56 BUS. LAW. 1287, 1296 (2001) (commenting that given the limited investment in publicly held firms directors are typically willing to make, any risk of director liability would dwarf the incentives for assuming the role); Bernard Black et al., Outside Director Liability, 58 STAN. L. REV. 1055, 1059 (2006) (noting that beyond some level of liability risk, qualified people may decide to not serve as directors and those who do serve may become excessively cautious).

4. See Melvin Aron Eisenberg, The Divergence of Standards of Conduct and Standards of Review in Corporate Law, 62 FORDHAM L. REV. 437, 444 (1993) (“It is often in the interests of shareholders that directors or officers choose the riskier of two alternative decisions, because the expected value of a more risky decision may be greater than the expected value of the less risky decision.”).


8. See Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 360 (Del. 1993) (“In exercising these powers [to manage the business and affairs of the corporation], directors are charged with an unyielding fiduciary duty to protect the interests of the corporation and to act in the best interests of its shareholders.”); William A. Klein et al., BUSINESS ORGANIZATIONS AND FINANCE 131 (8th ed. 2002); Lisa M. Fairfax, Spare the
incorporated,9 the hallmark fiduciary duties are the duties of care and loyalty.10 These two also involve a duty of candor to the corporation’s stockholders.11 These duties are discussed in Part II. Part II also explores a Delaware corporation’s director’s duty to act in good faith, explaining the intersection between the duty to act in good faith and the hallmark fiduciary duties of care and loyalty. Procedural mechanisms also play an important role in this analysis and can effectively determine the outcome of a fiduciary duty derivative suit. These mechanisms, as they relate to the Delaware fiduciary duty analysis, are presented in Part II.

The discussion in Part II focuses on Delaware law not only because Delaware is the state of incorporation for most U.S. corporations,12 but also because Delaware law often serves as a guide to courts in other jurisdictions in establishing their own fiduciary duty case law.13 For that reason, Delaware law is often thought of as supplying the national corporate law.14

But if Delaware corporate law is considered the national corporate

9. Hamilton et al., supra note 2, at 23; Renee M. Jones, Rethinking Corporate Federalism in the Era of Corporate Reform, 29 IOWA J. CORP. L. 625, 630, 632 (2004) (noting that 85% of out-of-state incorporations are in Delaware). There have been many reasons expounded for the dominance of Delaware corporate law, including its expert judiciary along with its specialized trial court system. Brown, supra note 1, at 347-48; Jones, supra note 9 at 632; Kahan et al., supra note 7, at 1604. Further, due to the large number of corporations incorporated in Delaware, there is an expansive, diverse body of case law that gives practitioners some guidance in determining how the Delaware judiciary might rule in a similar factual scenario. Klein et al., supra note 8, at 150; Brown, supra note 1, at 347-48; Mark J. Roe, Delaware’s Competition, HARV. L. REV. 588, 594 (2003).
12. See supra note 9 and accompanying text.
13. See Brown, supra note 1, at 347 (commenting that Delaware decisions interpreting management’s fiduciary obligations are widely followed by other states).
14. See Kahan et al., supra note 7, at 1591 (noting that Delaware is the leading supplier of corporate law).
law, the Sarbanes-Oxley Act of 2002\footnote{Pub. L. No. 107-204, 116 Stat. 745 (2002) (codified as amended in scattered sections of 11 U.S.C., 15 U.S.C., 18 U.S.C. and 29 U.S.C.).} is perhaps best described as its smash sequel. Congress enacted The Sarbanes-Oxley Act (SOX), in July of 2002, largely in response to Enron and other major accounting scandals that had shaken public confidence in the integrity of management’s financial and accounting practices and the ability of gatekeepers\footnote{“Gatekeepers” refers to outside directors, external auditors and external counsel, as they are the primary outsiders who serve as a check on management.} to detect and prevent those wrongful practices.\footnote{See Hamilton, Crisis, supra note 1, at 45 (noting that President Bush and the Republican-controlled House of Representatives recognized that the mood of America with respect to corporate governance changed radically after major accounting scandals at Enron, WorldCom, Adelphia, Tyco, Global Crossing, Qwest, Xerox, Rite Aid, ImClone and Merck, among others, and that an immediate legislative response was viewed as essential).} In a departure from the historic, limited role of federal securities laws in corporate governance, SOX codifies a host of responsibilities for directors of public companies and specifies various qualifications for board and committee service.\footnote{See discussion infra Part III. A “public company” refers to a company with a class of securities traded on a national stock exchange or with a class of securities having more than 500 record holders and with more than one million dollars in total assets. See 15 U.S.C. §§ 781(a), 781(g) (2000); 17 C.F.R. 240.12g-1 (2002).} Part III begins by reviewing the historic role of federal securities laws in corporate governance. Part III then turns to SOX and assesses those provisions of SOX that seem to fall squarely under the umbrella of corporate governance.

In conjunction with the passage of SOX, and largely at the behest of the Securities and Exchange Commission (the Commission), national securities exchanges and associations, which are self-regulatory associations (SROs), imposed new corporate governance standards on companies with securities listed on those exchanges. Part III summarizes those corporate governance listing standards relating to board composition and conduct, and explains how they relate to SOX.

By implementing corporate governance reform at the federal level, Congress has delivered a message that the balance between director accountability and enfranchisement must be tipped towards the former. Yet Congress did not include a mechanism for stockholders to enforce SOX’s corporate governance mandates under federal securities laws, nor has SOX expressly preempted state law as the primary source of the
Thus, any right to enforce those mandates is expected to come from state fiduciary duty law, the primary avenue available to stockholders to enforce directors’ duties.\(^{20}\) As Part IV presents, several recent court decisions reflect an increased focus on directors’ oversight responsibilities after the passage of SOX, suggesting that the courts are starting to incorporate, post-Reform, new expectations of directors into fiduciary duty law. While not uprooting the components or function of fiduciary duties, these cases indicate a refocusing of existing fiduciary duty law to bring about increased oversight by independent directors with financial experience. Part IV also explains how these duties may continue to shift, with the eyes of corporate America, Delaware judges and wary stockholders, on boardroom activity.

By refocusing fiduciary duty law, Delaware courts seem to be carrying out the SOX corporate governance mandates and the SRO corporate governance listing standards (together referred to as the Reform), at the state law level. But unlike the rules-based Reform, fiduciary duty law is standards based.\(^{21}\) This means that state fiduciary duty law develops as cases come before the Delaware judiciary. This allows state fiduciary duty law to be flexible and adaptive in response to changing norms.\(^{22}\) But particularly important in a climate of corporate change, it also provides some uncertainty as to what is required to satisfy a director’s fiduciary duties. With the shifting of indefinite standards of director conduct, how does a director know whether she has satisfied her fiduciary duties? That is undoubtedly the question directors are asking themselves. Part V suggests how directors might comply with their evolving fiduciary duties.

\(^{19}\) See Brown, supra note 1, at 375 (arguing that SOX does not alter the fiduciary standards applicable to officers and directors or to improve the procedural mechanism used to supplant substantive review); Johnson et al., supra note 6, at 1150 (arguing that SOX only modestly preempts fiduciary duties and noting that SOX does not contain an enforcement mechanism available to stockholders). See also discussion infra Part III.D.

\(^{20}\) See Brown, supra note 1, at 375.

\(^{21}\) Johnson et al., supra note 6, at 1151; Kahan et al., supra note 7, at 1598; see also William B. Chandler III et al., Views From the Bench: The New Federalism of the American Corporate Governance System: Preliminary Reflections of Two Residents of One Small State, 152 U. PA. L. REV. 953, 960 (2003) (noting that the Reform is proscriptive while fiduciary law is enabling).

\(^{22}\) Kahan et al., supra note 7, at 1598 (noting the flexible and highly fact-intensive nature of Delaware judge-made law).
II. TRADITIONAL NOTIONS OF FIDUCIARY DUTIES

Directors, as representatives elected to represent the interests of stockholders, owe fiduciary duties to those stockholders because they act on behalf of those stockholders. In Delaware, the hallmark fiduciary duties of directors are of care and loyalty. These duties are discussed in Parts II.A and II.B below. Parts II.C and II.D review two other duties which have traditionally been subsumed in the duties of care and loyalty—the duty of disclosure and the duty to act in good faith.

Stockholders can enforce directors’ fiduciary duties through either a direct suit on behalf of that stockholder, where there is damage personal to that stockholder, or through a derivative suit to enforce the directors’ duties on behalf of the corporation. The risk associated with allowing a stockholder to sue on behalf of a corporation is that quality directors may be hesitant to serve or make aggressive business decisions for fear of facing litigation over a “bad” decision. To address that risk, and the risk of courts second-guessing board decisions, Delaware courts presume that in making a business decision, directors acted in good faith.

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23. See Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 360 (Del. 1993); Fairfax, supra note 8; but see infra note 33 (challenging the ability of stockholders to elect and remove directors).


25. Stockholders can also seek to hold directors liable for committing corporate waste. Directors are liable for committing corporate waste where they approve “an exchange that is so one sided that no business person of ordinary, sound judgment could conclude that the corporation has received adequate consideration.” In re Walt Disney Co. Derivative Litig., 731 A.2d 342, 362 (Del. Ch. 1998), aff’d in part, rev’d in part sub nom. Brehm v. Eisner, 746 A.2d 244 (Del. 2000) [hereinafter Disney I]. Proving waste is exceptionally difficult. According to the Delaware Supreme Court, recovery under the waste doctrine is “confined to unconscionable cases where directors irrationally squander or give away corporate assets.” Brehm, 746 A.2d at 263. Because waste is exceptionally difficult to prove and seems to play a limited role in the Delaware courts’ fiduciary duty analyses, it is not discussed further herein. See Jaclyn J. Janssen, In re Walt Disney Company Derivative Litigation: Why Stockholders Should Not Put Too Much Faith in the Duty of Good Faith to Enhance Director Accountability, 2004 Wis. L. Rev. 1573, 1597 (2004) (noting that Delaware judges are reluctant to undertake a substantive review under the waste doctrine).


27. See generally, Eisenberg, supra note 4 (arguing that business decisions are necessarily made on the basis of incomplete information and in the face of obvious risk, so that a range of decisions is reasonable).
faith, on a fully informed basis, and in an honest belief that the action taken was in the best interest of the corporation.\footnote{28} This presumption is referred to as the business judgment rule.\footnote{29} Stockholders challenging director action can overcome that presumption only by showing that the board either breached its duty of loyalty, duty of care, or duty of good faith.\footnote{30} If a plaintiff successfully rebuts the business judgment rule, the burden then shifts to the defendant directors to prove that the transaction was fair to the stockholders.\footnote{31} This requires a showing that the transaction was the product of fair dealing and fair price.\footnote{32} Of course, if stockholders are unhappy with board decisions, they can either vote the board members out of office at the next election or sell their stock.\footnote{33} Delaware also has several other procedural barriers that protect directors from stockholder derivative suits for unwise or bad decisions. Those procedures are discussed below in Part II.E.

\footnote{28} \textit{Cede & Co.}, 634 A.2d at 360 (citing Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984)).
\footnote{29} \textit{Id.}; Aronson, 473 A.2d at 812.
\footnote{30} \textit{Cede & Co.}, 634 A.2d at 361; Emerald Partners v. Berlin, 787 A.2d 85, 91 (Del. 2001); \textit{but see} discussion \textit{infra} Part II.D as to the duty of good faith.
\footnote{31} \textit{Cede & Co.}, 634 A.2d at 361; Mills Acquisition Co. v. MacMillan, Inc., 559 A.2d 1261, 1279 (Del. 1989).
\footnote{32} \textit{Cede & Co.}, 634 A.2d at 361.
\footnote{33} The ability of stockholders of public companies to vote directors out of office has been questioned by many commentators who argue that stockholders have little power to nominate new directors to the board, and thus only have the power to consider and approve management’s nominees. \textit{See, e.g.}, Seth W. Ashby, \textit{Strengthening the Public Company Board of Directors: Limited Shareholder Access to the Corporate Ballot vs. Required Majority Board Independence}, 2005 Ill. L. Rev. 521, 528 (2005) (commenting that the stockholder franchise is only ceremonial because executive management controls whose name appears on the corporate ballot); Chandler et al., \textit{supra} note 21, at 999 (“As of now, incumbent slates are able to spend their companies’ money in an almost unlimited way in order to get themselves reelected. As a practical matter, this renders the corporate election process an irrelevancy . . . ”); Leo E. Strine Jr., \textit{Derivative Impact? Some Early Reflections on the Corporation Law Implications of the Enron Debacle}, 57 Bus. Law. 1371, 1377 (2002) (arguing that the nominating committee tilts in favor of the incumbent directors and the incumbent’s and management’s candidates over candidates nominated by stockholders).
A. Duty of Care

1. Business Decision Context

The business and affairs of a Delaware corporation are managed by or under its board of directors. The duty of care requires that directors inform themselves of all material information reasonably available before voting on a transaction. A board can retain consultants or other advisors in becoming informed, and is protected in relying on statements, information and reports furnished by those advisors, so long as it does so in good faith, and selected the advisors with reasonable care. Under the business judgment rule, a board that has approved a specific action will be presumed to have acted in good faith, on a fully informed basis, and in an honest belief that the action taken was in the best interest of the corporation. To rebut that presumption, and to establish that a board breached its duty of care, a plaintiff must prove that the board failed to inform itself of all material information reasonably available and that failure amounted to gross negligence.

One of the most significant duty of care cases in the last thirty years is Smith v. Van Gorkom. In Van Gorkom, the Delaware Supreme Court held that the board of Trans Union had breached its duty of care in approving a merger at a meeting called on one day’s notice and without

36. Section 141(e) of the Delaware General Corporation Law (DGCL), provides as follows:
A member of the board of directors, or a member of any committee designated by the board of directors, shall, in the performance of such member’s duties, be fully protected in relying in good faith upon the records of the corporation and upon such information, opinions, reports or statements presented to the corporation by any of the corporation’s officers or employees, or committees of the board of directors, or by any other person as to matters the member reasonably believes are within such other person’s professional or expert competence and who has been selected with reasonable care by or on behalf of the corporation.
38. Aronson, 473 A.2d at 812.
39. 488 A.2d 858 (Del. 1985); Brown, supra note 1, at 340 (arguing that Van Gorkom is the only significant Delaware Supreme Court case in the last thirty years which has resulted in the inapplicability of the business judgment rule and the imposition of liability on directors of a public company for breach of the duty of care).
having received any information as to the merger other than a statement by the chairman that the merger price was fair. The board of Trans Union was not entitled to the benefit of the business judgment rule presumption because of its failure to act on an informed basis, and was held liable.

*Van Gorkom* gave directors a wake up call; it made them realize the possibility of personal liability for their board service. The Delaware legislature reacted a year later by enacting Section 102(b)(7) of the Delaware General Corporation Law (DGCL). Under Section 102(b)(7), a corporation may waive monetary damages arising from a director’s breach of the duty of care by including a charter provision to that effect. But no director may be relieved or “exculpated” from liability where she is found to have acted in bad faith, breached her duty of loyalty, or to have knowingly violated law or engaged in misconduct. As a result, directors of Delaware corporations are generally not liable for breaching their duty of care, unless exculpation is precluded by one of the noted exceptions in Section 102(b)(7).

Under Section 145(a) of the DGCL, a corporation may indemnify a director for any liability arising out of her service as a director, but only for actions in good faith which she reasonably believed were in, or not

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41. *Id.* at 884.
42. Emerald Partners v. Berlin, 787 A.2d 85, 90 (Del. 2001) (noting that the Delaware legislature enacted Section 102(b)(7) of the DGCL the year after *Van Gorkom* was decided); Cinerama, Inc. v Technicolor, Inc., 663 A.2d 1156, 1166 n.18 (Del. 1995) (noting that Section 102(b)(7) of the DGCL was a legislative response to the Delaware Supreme Court’s liability holding in *Van Gorkom*).
43. Section 102(b)(7) of the DGCL provides as follows:
   (b) In addition to the matters required to be set forth in the certificate of incorporation by subsection (a) of this section, the certificate of incorporation may also contain any or all of the following matters: . . . (7) A provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, provided that such provision shall not eliminate or limit the liability of a director: (i) for any breach of the director’s duty of loyalty to the corporation or its stockholders; (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law; (iii) under § 174 of this title; or (iv) for any transaction from which the director derived an improper personal benefit.

44. *Id.*
45. *Id.*; see also Black et al., *supra* note 3, at 1060 (noting that *Van Gorkom* is the only case where outside directors made out-of-pocket payments after a trial).
opposed to, the best interest of the corporation. While indemnification under Section 145 does not absolve a director from liability as in the case of a Section 102(b)(7) charter provision, it does permit a director to be made whole for any loss or damages incurred as a result of a fiduciary duty suit against her, so long as indemnification is not statutorily precluded.

Considering the business judgment rule presumption, and in light of the prevalence of exculpatory charter provisions, it is not surprising that no Delaware court since Van Gorkom has premised director liability solely on a breach of the duty of care. This has led several commentators to conclude that the fiduciary duty of care exists only as an aspirational and unenforceable standard.

2. Oversight Context

Even when not faced with a business decision, a board must oversee the business and affairs of the corporation on which it serves under Section 141(a) of the DGCL. The board’s exercise of this oversight function is not entitled to the benefit of the business judgment rule presumption because there is no business decision to presume correct. Thus the business judgment rule does not apply where a board abdicates its responsibility to oversee a corporation’s business and affairs, or where it fails to act absent a conscious decision to not act. In the alternative, where a board consciously decides to not act, this choice does in fact amount to a business decision.

One of the first duty of care cases in the oversight context was Graham v. Allis Chalmers. In this case, several stockholders of Allis-

47. Indemnification is only meaningful where the corporation is solvent and can make good on its indemnity undertaking. See Black et al., supra note 3, at 1083-84.
48. Klein et al., supra note 8, at 157; Black et al., supra note 3, at 1060.
49. Jones, supra note 9, at 648 (citing Klein et al., supra note 8, at 151-54); see also Thompson et al., supra note 5, at 866 (commenting that absent violations of loyalty, good faith or some intent to harm the corporation or its stockholders, directors are exculpated from liability for a breach of their fiduciary duty of care).
52. Id.
53. Id.
54. Graham v. Allis Chalmers, 188 A.2d 125, 127 (Del. 1963). In Allis Chalmers,
Chalmers sued four convicted employees and the directors, seeking to recover fines paid by the company for violating antitrust laws. Though the defendant directors proved that they did not know about the violations, the plaintiffs argued that the directors should have known about the violations as they should have put a system in place designed to bring any antitrust activity to their attention. The Delaware Supreme Court did not buy this argument, holding that “absent cause for suspicion there is no duty upon the directors to install and operate a corporate system of espionage to ferret out wrongdoing which they have no reason to suspect exists.” Applying this principle, the court found that the Allis-Chalmers directors did not breach their duty of care, for as soon as they had grounds to suspect that employees were engaging in anticompetitive activities, they acted promptly to end those activities and to prevent them from recurring.

Perhaps the most significant oversight case, decided nearly thirty years after Allis Chalmers, is In re Caremark International Inc. Derivative Litigation. In Caremark, Caremark was assessed fines for violating an anti-referral payments law prohibiting health care providers from paying any form of remuneration to doctors or hospitals to induce the referral of Medicare or Medicaid patients. Caremark was found to have violated the law despite its adoption and implementation of a guide specifying the types of contracts it was able to enter into with physicians and hospitals under the anti-referral law, and its implementation of an internal audit plan to audit compliance with that guide. Several stockholders brought a derivative suit against Caremark’s directors, alleging that they breached their duty of care by failing to detect and

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Allis-Chalmers Manufacturing Company and four of its employees were convicted for violating federal antitrust laws and were assessed fines for these violations. Id.

55. Id.
56. Id. at 127, 130.
57. Id. at 130.
58. Id. at 130-31.
59. In re Caremark International Inc. Derivative Litigation, 698 A.2d 959 (Del. Ch. 1996). In Caremark, the Chancery Court was asked to approve the terms of a settlement as “fair and reasonable” under Chancery Court Rule 23.1. Id. at 960. But the court took the opportunity of the settlement order to expound on the duty of care in the oversight context.
60. Id. at 961-62.
61. Id. at 962-63.
prevent Caremark’s illegal activities.\textsuperscript{62}

In its decision, the Delaware Chancery Court distinguished the duty of care in the context of a board decision from the context of unconsidered inaction.\textsuperscript{63} In the board decision context, the duty of care requires that the board decision be the product of a good faith effort by the directors to be informed and to exercise judgment.\textsuperscript{64} According to the Chancery Court, this inquiry looks to the process employed and not the substance of the board decision.\textsuperscript{65} But where a board is not considering any decision, compliance with its duty of care requires that the board ensure that the corporation functions within the law to achieve its purpose.\textsuperscript{66} In performing this function, the court cautioned that a board needs to consider the organizational sentencing guidelines, which may result in significant sanctions on corporations for misdeeds.\textsuperscript{67} Moreover, a board needs relevant and timely information to satisfy this oversight role.\textsuperscript{68} To be reasonably informed under this duty, a board must determine, in its good faith judgment,

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\text{[t]hat information and reporting systems exist in the organization that are reasonably designed to provide to senior management and to the board itself timely, accurate information sufficient to allow management and the board, each within its scope, to reach informed judgments concerning both the corporation’s compliance with law and its business performance.} \textsuperscript{69}
\]

But “only a sustained or systematic failure of the board to exercise oversight—such as an utter failure to attempt to assure a reasonable information and reporting system exits [sic]—will establish the lack of good faith that is a necessary condition to liability.”\textsuperscript{70} While the Caremark obligation to establish a reporting system appears to contradict the Delaware Supreme Court’s holding in \textit{Allis-Chalmers}, relieving directors from the duty to install and operate a “corporate system of espionage to ferret out wrongdoing,” the Chancery Court

\textsuperscript{62} \textit{Id.} at 964.
\textsuperscript{63} \textit{Id.} at 967.
\textsuperscript{64} \textit{Id.} at 968.
\textsuperscript{65} \textit{Id.} at 967-68.
\textsuperscript{66} \textit{Id.} at 969.
\textsuperscript{67} \textit{Id.} at 970.
\textsuperscript{68} \textit{Id.}
\textsuperscript{69} \textit{Id.}
\textsuperscript{70} \textit{Id.} at 971.
interpreted *Allis-Chalmers* narrowly to eliminate any perceived conflict.\(^{71}\)

### B. Duty of Loyalty

The fiduciary duty of loyalty mandates that a director exercise undivided and unselfish loyalty to the corporation on whose board he serves, and that he place the best interests of the corporation and its stockholders ahead of any interest of his own, any officer, or any controlling stockholder not shared by the other stockholders.\(^{72}\) Classic examples of director self-dealing involve either a director appearing on both sides of a transaction or a director receiving a personal benefit from a transaction not received by the corporation’s stockholders.\(^{73}\) The business judgment rule presumption applies to a board’s decision, notwithstanding that the transaction being approved is an interested party transaction.\(^{74}\) But Delaware courts are given flexibility in determining whether a director’s interest in a transaction is sufficiently material so as to constitute a breach of the duty of loyalty, and thus not entitled to the protection of the business judgment rule.\(^{75}\) Where a plaintiff demonstrates a breach of this duty, the burden shifts to the defendant directors to prove that the transaction is fair to the stockholders.\(^{76}\)

To avoid the need for a court determination of the fairness of every challenged interested party transaction, there is a mechanism in Delaware to remove the “interested director cloud.”\(^{77}\) This mechanism, codified in Section 144(a) of the DGCL, provides that a transaction in which a director is interested is not void, or voidable, if either a majority of disinterested directors or a majority of stockholders, in good faith, authorizes the transaction after full disclosure.\(^{78}\) For this purpose, a

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\(^{71}\) *See id.* at 969.

\(^{72}\) *Cede & Co.* v. United Technicolor, 634 A.2d 345, 361 (Del. 1993); Guth v. Loft, 5 A.2d 503, 510 (Del. 1939).

\(^{73}\) *Cede & Co.*, 634 A.2d at 362.

\(^{74}\) *Id.* at 363.

\(^{75}\) *Id.* at 364.

\(^{76}\) *Id.* at 361; *Mills Acquisition Co.* v. MacMillan, Inc., 559 A.2d 1261, 1279 (Del. 1989).

\(^{77}\) *Cede & Co.*, 634 A.2d at 365-66.

\(^{78}\) *Del. Code Ann.* tit. 8, § 144(a) (2005). Section 144(a) of the DGCL does not preclude an interested director from being involved in the decision-making process in
director is considered disinterested if he does not appear on both sides of a transaction, nor expects to derive a material personal financial benefit from the transaction.\(^{79}\) Where either a majority of disinterested directors or a majority of stockholders approves in good faith an interested party transaction, a court will apply the business judgment rule to the decision to enter into that transaction.\(^ {80}\)

**C. Duty of Candor/Disclosure**

The duty of candor mandates that directors disclose all available material information to stockholders when obtaining their approval.\(^ {81}\) Omitted information is “material” if a reasonable stockholder would consider it important in deciding how to vote.\(^ {82}\) To prove a breach of the duty of candor outside of the context of an interested party transaction, a stockholder must show that the information omitted from a stockholder solicitation was material and reasonably available, and a reasonable stockholder would consider that information important in deciding how to vote.\(^ {83}\) A director will only be required to pay damages for a breach of the duty of candor where the breach impaired the economic or voting rights of stockholders, and even then may be liable for only nominal damages.\(^ {84}\) Moreover, a board that breaches its duty of candor is entitled to exculpation under a Section 102(b)(7) exculpatory charter provision.\(^ {85}\)

In the context of an interested party transaction, the duty of candor mandates that directors not use superior information or knowledge to which she is interested. The duty of disclosure is discussed *infra* in Section C.

\(^ {79}\) Orman v. Cullman, 794 A.2d 5, 23 (Del. Ch. 2002).

\(^ {80}\) Marciano v. Nakash, 535 A.2d 400, 405 n.3 (Del. 1987). Some commentators believe that the business judgment rule applied in that context is heightened from that which applies in the non-interested party context. *See, e.g.*, Eisenberg, *supra* note 4, at 455 (arguing that no approval of a self-interested transaction by disinterested directors will prevent a court from applying a “smell” test that is more rigorous than the business judgment rule).

\(^ {81}\) McMullin v. Beran, 765 A.2d 910 (Del. 2000); Loudon v. Archer-Daniels-Midland Co., 700 A.2d 135, 143 (Del. 1997); Cede & Co., 634 A.2d at 372 (referring to Stroud v. Grace, 606 A.2d 75, 84 (Del. 1992)).

\(^ {82}\) McMullin, 765 A.2d at 925; Rosenblatt v. Getty Oil Co., 493 A.2d 929, 944 (Del. 1985).

\(^ {83}\) Archer-Daniels-Midland Co., 700 A.2d at 143.

\(^ {84}\) Id. at 142.

\(^ {85}\) Id.
mislead stockholders voting on the transaction.\textsuperscript{86} According to the Delaware Supreme Court, this duty is one of the “elementary principles of fair dealing.”\textsuperscript{87} Where stockholders are not provided with all material information reasonably available when approving an interested party transaction, that approval is ineffective under Section 144(a) of the DGCL for purposes of removing the interested party taint.\textsuperscript{88} Thus, the board must prove the fairness of the transaction though it may be difficult to prove fair dealing in light of the omitted disclosure.\textsuperscript{89}

This broad duty of candor is quite different from the disclosure mandates of federal securities laws, laws enumerating in detail what must be disclosed to stockholders of public companies.\textsuperscript{90} But Delaware courts have historically looked to federal securities law disclosure standards in shaping the state fiduciary duty of disclosure.\textsuperscript{91}

\textbf{D. Duty of Good Faith}

Delaware courts have at times referred to a “triad” of fiduciary duties, encompassing the duties of care, loyalty and good faith.\textsuperscript{92} But Delaware courts have traditionally not held that a separate duty of good faith exists.\textsuperscript{93} They also have not clearly defined what good faith means beyond stating that it involves the need to act in the best interests of the stockholders.\textsuperscript{94} In one case, the Delaware Chancery Court held that bad

\begin{itemize}
\item \textsuperscript{86} Mills Acquisition Co. v. MacMillan, Inc., 559 A.2d 1261, 1283 (Del. 1989).
\item \textsuperscript{87} Id.
\item \textsuperscript{88} See Del. Code Ann. tit. 8, § 144(a) (2005); see also discussion supra Part II.B.
\item \textsuperscript{89} Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 366 (Del. 1993).
\item \textsuperscript{90} The federal securities law disclosure regime is discussed infra in Part III.
\item \textsuperscript{91} See Rosenblatt v. Getty Oil Co., 493 A.2d 929, 944 (Del. 1985) (adopting federal materiality standard).
\item \textsuperscript{92} See, e.g., Emerald Partners v. Berlin, 787 A.2d 85, 90 (Del. 2001); Cede & Co., 634 A.2d at 361; McMullin v. Beran, 765 A.2d 910, 917 (Del. 2000).
\item \textsuperscript{93} Tara L. Dunn, \textit{The Developing Theory of Good Faith in Director Conduct: Are Delaware Courts Ready to Force Corporate Directors to Go Out-of-Pocket After Disney IV?}, 83 Denv. U. L. Rev. 531, 545 (2005) ("Case law demonstrates the courts’ historical uncertainty as to whether good faith is an independent duty, a component of the duty of care, or a component of the duty of loyalty."); see Janssen, supra note 25, at 1581 (noting the debate among Delaware judges as to whether a distinct duty of good faith exists); see, e.g., Cede & Co., 634 A.2d at 361, 367 (referring to the “triad” of fiduciary duties, but subsequently referring to the duties of care and loyalty as the traditional hallmark fiduciary duties).
\item \textsuperscript{94} See, e.g., Barkan v. Amsted Industries, Inc., 567 A.2d 1279, 1286 (Del. 1989)
\end{itemize}
faith may be inferred where a decision is so far beyond the bounds of reasonable judgment it seems essentially inexplicable on any ground other than bad faith. This formulation of bad faith seems to allow an inference of a bad faith mental state when, in looking at the substance of a decision, a court cannot find any other basis for that decision. Still, this formulation does not explain what bad faith means, or when a bad decision will lead to an inference of bad faith. On the other hand, the Delaware Chancery Court’s formulation of bad faith in Caremark leads to an inference of bad faith where there is an “utter failure to attempt to assure a reasonable information and reporting system exists [sic].”

This formulation focuses on the process employed by the board when determining bad faith, inferring a bad faith mental state where an inadequate information-gathering process is employed. According to some commentators, a lack of clarity in defining and interpreting good faith has prevented it from traditionally commanding attention in stockholder suits.

E. Demand Futility and the Special Litigation Committee

Delaware law provides that a stockholder may commence a derivative suit to enforce a cause of action on behalf of a corporation. Where a stockholder intends to bring a derivative action to enforce a director’s breach of a fiduciary duty, Delaware Chancery Rule 23.1 requires that the stockholder first make demand on the board to proceed with that cause of action. This demand requirement reveals that even in the face of litigation, the board retains power to oversee corporate affairs. But this demand requirement is dispensed with where it

(equating good faith with loyalty); Orman v. Cullman, 794 A.2d 5, 14 n.3 (Del. Ch. 2002) (“[T]he duty to act in ‘good faith’ is merely a subset of a director’s duty of loyalty . . . .”); In re Gaylord Container Corp. S’holder Litig., 753 A.2d 462, 476 (Del. Ch. 2000) (explaining that good faith is a “fresh” way to refer to the duty of loyalty).


97. Dunn, supra note 93, at 545; see also Janssen, supra note 25, at 1583 (arguing that conflicting approaches to the duty of good faith made it an ambiguous concept).


would be futile. The rationale behind this demand futility exception is to save stockholders the expense and delay of making a demand likely to result in a tainted exercise of authority by the board. To show demand futility, a plaintiff must create a reasonable doubt that the directors are disinterested and independent, or that the challenged transaction was the product of a valid exercise of business judgment.

Traditionally, to prove a director’s non-independence in the context of demand futility, a plaintiff must show that the director’s decision was based on extraneous considerations rather than the corporate merits of the matter before the board. This is generally shown where a director is dominated or controlled by an interested party. A director is interested when he will receive a personal financial benefit from a transaction not shared by the stockholders, or where a corporate decision will have a materially detrimental impact on him but not on the corporation or its stockholders. The possible threat of liability as a result of a director having approved a challenged transaction is generally insufficient to show that the director either is interested or not independent.

Even where demand is excused, the board retains the right to make decisions regarding corporate litigation. Thus a board has the power

102. Zapata Corp., 430 A.2d at 786.
103. Aronson, 473 A.2d at 814. A court will not apply the Aronson test for demand futility where the board considering the demand did not make the business decision being challenged, such as where the decision was made by the board of a corporation but a majority of the directors who made the challenged decision have been replaced, where the subject of the derivative suit is not a business decision of the board or where the decision being challenged was made by the board of a different corporation. Rales v. Blasband, 634 A.2d 927, 933-34 (Del. 1993). In those cases, a court will examine whether a majority of the board could have properly exercised its independent and disinterested business judgment in responding to a demand. Id. at 934.
104. Rales, 634 A.2d at 936; Aronson, 473 A.2d at 816.
105. Rales, 634 A.2d at 936; Aronson, 473 A.2d at 815.
106. Rales, 634 A.2d at 936.
107. Aronson, 473 A.2d at 815. In contrast, where a plaintiff establishes that a board acted for entrenchment purposes, that is sufficient to exclude the requirements of demand. Carmody v. Toll Bros., Inc., 723 A.2d 1180, 1189 (Del. Ch. 1998). See also Grobow v. Perot, 526 A.2d 914, 923 n.12 (Del. Ch. 1987) (acknowledging that under certain circumstances, directors’ fees might become so lavish that they might alone establish a director’s interest).
to decide whether dismissal of litigation is in the best interests of the corporation. \(^\text{109}\) The board has this authority, even if fellow directors are involved in the litigation, so long as the authority over litigation is delegated to an independent committee of disinterested directors, often referred to as a special litigation committee (SLC). \(^\text{110}\) Delaware courts acknowledge the inherent risk of abuse, however subconscious, in those circumstances. \(^\text{111}\) To address this, courts place the burden of proving: that the SLC was comprised of independent, disinterested directors; that those directors conducted a reasonable investigation; and that they reached, in good faith, a business judgment that the litigation is not in the best interest of the corporation, on the corporation. \(^\text{112}\) To determine whether SLC members are independent, courts generally analyze whether the members were able to independently conduct investigations and prepare reports regarding the decision to grant a motion to dismiss, \(^\text{113}\) considering factors such as whether the SLC members were on the board at the time of the challenged action, and whether they were named as defendants in the action. \(^\text{114}\) But even if a corporation sufficiently proves each of these factors, a court will still apply its own independent business judgment to determine whether or not dismissal of the litigation is proper. \(^\text{115}\)

### III. Federal Securities Laws and SRO Listing Standards as Sources of Corporate Governance

#### A. Historic Role of Securities Laws and SRO Listing Standards

While traditional notions of fiduciary duties derive from state common law, fiduciary duties, to an extent, have also been shaped by federal securities laws and SRO listing standards. Federal securities laws generally regulate public companies by mandating disclosures that must be provided to investors, ensuring that investors have enough

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109. Id.
110. Id.
111. Id. at 787.
112. Id. at 788.
114. See Lewis, 502 A.2d at 966-67.
115. Zapata Corp., 430 A.2d at 789.
information about those companies to make investment decisions.\textsuperscript{116} Many of the disclosure requirements relate to corporate governance practices. For example, The Securities Exchange Act of 1934,\textsuperscript{117} known as the Exchange Act, requires each public company to disclose, in its annual report to stockholders, whether or not it has standing audit, nominating and compensation committees; if it does not, it must explain why.\textsuperscript{118} While merely a disclosure rule, this requirement obligates a board to either establish those committees, or form a basis for not having them, which must then be disclosed to investors. In this way, federal securities laws influence director conduct by regulating disclosure.\textsuperscript{119} The Exchange Act has historically regulated some corporate governance practices directly, particularly those affecting stockholders’ voting franchise.\textsuperscript{120} But there, too, the focus has been on implementing a process that ensures stockholders receive full and fair disclosure.\textsuperscript{121}

The national stock exchanges and associations have also regulated some conduct falling within the ambit of corporate governance.\textsuperscript{122} For

\textsuperscript{116} Hamilton et al., \textit{supra} note 2, at 13-14; Hazen, \textit{supra} note 5, at 799; Thompson et al., \textit{supra} note 5, at 909 (noting that the original premise for disclosure was to decrease information asymmetries and thereby to improve market efficiency through accurate information, while stopping short of creating a body of federal corporate law).


\textsuperscript{119} Brown, \textit{supra} note 1, at 350-52 (noting instances where the Commission used disclosure to force changes at the board level); Chandler et al., \textit{supra} note 21, at 974 ("[M]any federal disclosure requirements have had the natural and (presumably) intended consequence of influencing boardroom practices.”).

\textsuperscript{120} See Roe, \textit{supra} note 9, at 632-33 (arguing that in the 1990s, even before SOX, federal authorities were adjusting the balance between managers and stockholders in proxy contests, stockholder proposals and institutional investor voice); Thompson et al., \textit{supra} note 5, at 870 (arguing that the most significant and direct extension into the corporate governance realm occurs when proxies are solicited to gain stockholder votes which may be required by state law). Other securities laws mandate specific conduct, but they generally relate to specific types of companies or securities. See, e.g. THE INVESTMENT COMPANY ACT OF 1940, 15 U.S.C. § 80a-1 \textit{et seq}. (regulating mutual funds and other investment companies), and THE TRUST INDENTURE ACT OF 1939, 15 U.S.C. § 77aaa \textit{et seq}. (regulating bonds, debentures and other similar debt securities offered for public sale and issued under large trust indentures).

\textsuperscript{121} 15 U.S.C. § 78n \textit{et seq}.; 17 C.F.R. 240.14a; see also Thompson et al., \textit{supra} note 5, at 871 (noting that federal law regulates the process of disclosure where stockholder participation is solicited).

instance, since the 1970s, both the New York Stock Exchange (NYSE) and the National Association of Securities Dealers (NASD) have required listed companies to have a specified number of independent directors on their audit committees. One of the SROs’ primary goals in regulating corporate governance matters has been to lend stability to capital markets by permitting access only to issuers with “good” governance practices. But the SROs’ corporate governance requirements have not traditionally been particularly burdensome or substantial. Moreover, the most severe remedy for a violation of SRO listing standards is delisting, a result that does not punish the directors responsible for a corporation’s failure to comply with corporate governance listing standards. In addition, listing securities with an SRO is voluntary. Thus, a corporation can avoid being subject to an SRO’s listing standards by either not listing or de-listing its securities.

B. The Enactment of SOX and SRO Corporate Governance Listing Standards

While the pre-2002 state-federal-SRO corporate governance balance seemed to function adequately during the stock market boom of the 1990s, it may have become imbalanced following the dot-com and telecom bubble bursts. As the economy began to contract in 2000 and

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124. Id. at 1497. Some SROs have also passed listing standards directed toward corporate governance as a way to create a brand name associated with high quality. Id.
125. Chandler et al., supra note 21, at 973 (“The Exchanges have played a more mixed role, through listing requirements and the rules of some diversity, but generally with non-burdensome effects.”).
126. Brown, supra note 1, at 372; Chandler et al., supra note 21, at 983.
127. The consequence of de-listing, however, is that there will not be an established market for trading in those securities. Interestingly, only about half of all public companies have securities listed for trading with one of the SROs. Leisner, supra note 122, § II-8-24 to 25.
128. See John C. Coffee, Jr., What Caused Enron? A Capsule Social and Economic History of the 1990s, 89 CORNELL L. REV. 269, 271-72 (2004) (arguing that the explosion of financial irregularities in 2001 and 2002 were the natural and logical consequence of trends and forces that had been developing for some time, including the end of the stock market bubble and the emergence of a system of corporate governance where corporate managers were accountable to the market); see also Hamilton, Crisis,
2001 at the end of the dot-com and telecom booms, stock prices began to plummet, leading to staggering investor losses and market skepticism. That skepticism seemed to grow with every new financial restatement indicating that management had managed earnings to inflate stock prices, enabling them to receive large cash bonuses and payouts upon the exercise of options. Additionally, the failures of accounting firms and directors to keep those accounting abuses in check became widely known and criticized. Whatever may have caused the massive

supra note 1, at 13, 16 (noting the bursting of the dot-com bubble in 2000 as the dot-com businesses began to disappear, and the collapse of the telecommunications industry in early 2001 as it became clear that overcapacity would be a problem); Larry E. Ribstein, In the Wake of Corporate Reform: One Year in the Life of Sarbanes-Oxley—A Critical Review Symposium Issue: SARBOX: The Road to Nirvana, 2004 Mich. St. L. Rev. 279, 281 (2004) (arguing that the bubble atmosphere was created by several factors, including the nurturing, at Enron and others, of a breed of highly competitive, unrealistically over-confident, and ultimately unethical business people, the creation of new business techniques which made financial statements opaque, and the disappearance of a healthy skepticism).

129. See Hamilton, Crisis, supra note 1, at 13, 16.

130. Roberta Romano, The Sarbanes-Oxley Act and the Making of Quack Corporate Governance, 114 Yale L.J. 1521, 1524-25 (2005) (noting that in 2002 there was a shift in public mood regarding big business, coinciding with the high-profile corporate scandals and financial distresses as well as a sharp decline in the stock market); Joel Seligman, F. Hodge O’Neal Corporate and Securities Law Symposium: Conflicts of Interest in Corporate and Securities Law: No One Can Serve Two Masters: Corporate and Securities Laws After Enron, 80 Wash. U. L.Q. 449, 466-67 (2002) (noting that the number of restatements grew from 116 in 1997 to 305 in 2001, and that following Enron, newspapers were reporting a market-wide dampening of stock prices because of uncertainty as to whether the accounting, auditing and corporate governance problems at Enron would prove to be widespread).

131. See Coffee, supra note 128, at 297-98 (arguing that managerial incentives changed in the 1990s as executive compensation shifted toward being equity-based, encouraging management to engage in short-term rather than long-term price maximization); Seligman, supra note 130, at 477 (noting various factors that undermined investor confidence in financial information and market efficiency, including the dramatic reversal of public companies’ financial conditions, corresponding with significant losses by investors, the revelation of accounting irregularities at public companies, including at well-regarded companies, and the number of financial restatements).

132. See Coffee, supra note 128, at 300-01 (arguing that under the irrational market theory, during a market bubble, gatekeepers increase their financial positions by acquiescing in managerial misbehavior); see also Brown, supra note 1, at 357 (arguing that with the collapse of Enron, the market confronted widespread examples of
accounting abuses and seeming breakdown in firm ethos, directors were caught in the middle, as they are the linchpin in the system of corporate governance.

Congress responded to the accounting scandals, major corporate collapses, and sinking investor confidences without delay, enacting SOX eight months after Enron’s bankruptcy, and a mere nine days after WorldCom’s collapse.\footnote{See Hamilton, \textit{Crisis}, supra note 1, at 13, 40 (noting that the Sarbanes-Oxley Act was the immediate response to the corporate governance crisis following the collapse of the dot-com and telecom bubbles).} In fact, the Congressional record relating to the passage of SOX is replete with references to Enron and the failures of its directors to detect and prevent accounting improprieties.\footnote{See S. COMM. ON BANKING, HOUSING, AND URBAN AFFAIRS, S. Rep. No. 107-205 (June 26, 2002), \textit{reprinted in} 107 S. Rpt. 205 (July 3, 2002) [hereinafter \textit{SENATE REPORT}] (mentioning Enron twelve times).}

SOX not only adds disclosure requirements relating to matters of public company corporate governance, but also mandates additional oversight duties and specifies independence criteria for directors serving on public company audit committees.\footnote{See discussion infra Part III.C.} SOX further aims to strengthen the audit committee by requiring disclosure of financial expertise on the audit committee.\footnote{See id.} As many commentators have noted, SOX regulates corporate governance of public companies more aggressively than previously effectuated through federal securities laws.\footnote{See Hazen, \textit{supra} note 5, at 800 (noting a departure after SOX from the dichotomy where the states had defined officers’ and directors’ duties and federal securities laws had regulated information provided to investors); Chandler et al., \textit{supra} note 21, at 959 (“[T]he 2002 Reforms appear to be a relatively aggressive move by the federal government and the Exchanges into the realm of board decision making and composition, an area where traditionally, the states have been predominant.”); Johnson et al., \textit{supra} note 6, at 1150 (noting that SOX makes unprecedented federal inroads into the area of corporate governance); Thompson et al., \textit{supra} note 5, at 874 (noting that post-SOX, the Exchange Act defines federal standards of directors’ responsibilities in the ordinary operation of business enterprises).}

It is curious that Congress moved so quickly and pointedly into the corporate governance arena, given its historic, limited role in the field,
instead of leaving regulation of corporate governance to the states. Several theories have been advanced to explain this departure. According to some academics, there was immense political pressure on Congress to react quickly and visibly after Enron and other accounting “scandals,” in order to restore investor confidence in the capital markets.\textsuperscript{138} Another view is that states may not have been capable of providing a satisfactory response to the systemic weakness in board oversight of management.\textsuperscript{139} Others argue that states may have avoided enacting burdensome or controversial legislation in an effort to avoid losing corporate charters to other states with less burdensome legislation.\textsuperscript{140} In addition, state courts might not have been able to respond quickly, due to their adherence to the doctrine of \textit{stare decisis}, and their need to wait for cases to properly come before them before effecting any change in fiduciary duty law.\textsuperscript{141} Whatever the reason,

\begin{itemize}
\item \textsuperscript{138} See Chandler et al., \textit{supra} note 21, at 957 (arguing that the Reform is typical of major remedial measures that result from our political process, suffering from the rapidity of enactment and a tendency to deal with many issues superficially and sporadically); Lawrence A. Cunningham, \textit{Symposium: Crisis in Confidence: Corporate Governance and Professional Ethics Post-Enron Sponsored by Wiggin & Dana: The Sarbanes-Oxley Yawn: Heavy Rhetoric, Light Reform (And It Might Just Work)}, 35 \textit{CONN. L. REV.} 915, 917 (2003) (arguing that Congress used the episodic power opportunity created by the parade of accounting and corporate governance scandals to pass SOX); Hamilton, \textit{Crisis, supra} note 1, at 45-46 (arguing that the Sarbanes-Oxley Act was the only piece of corporate governance legislation in the pipeline at the time the list of accounting scandals had broadened to include Enron, WorldCom, Adelphia, Tyco and Global Crossing, among others, yet an immediate legislative response was viewed as essential); see also Romano, \textit{supra} note 130, at 1527-29 (discussing the trumped political process involved in the passage of SOX).
\item \textsuperscript{139} See Kahan et al., \textit{supra} note 7, at 1588-89 (arguing that in a time of crisis or scandal, the federal government will intervene since it is at that time that Delaware’s lack of political legitimacy is made and resonates); \textit{but see} Dunn, \textit{supra} note 93, at 535 (arguing that Delaware’s courts were crafting their guidance to the new corporate governance environment before the collapses of Enron and WorldCom).
\item \textsuperscript{140} See Kahan et al., \textit{supra} note 7, at 1590, 1594-95 (noting political constraints placed on Delaware which prevent it from making systemic changes in fiduciary duty law due to jurisdictional and conflict rules, and also noting the rarity of the legislature overturning judge-made corporate law).
\item \textsuperscript{141} Dunn, \textit{supra} note 93, at 541; Kahan et al., \textit{supra} note 7, at 1598-99 (noting that the Delaware Supreme Court rarely overrules its own precedents and instead justifies its rulings by qualifying them as applicable to a narrower set of circumstances or as having been misinterpreted by lawyers or lower court judges); see also E. Norman Veasey, \textit{Counseling Directors in the New Corporate Culture}, 59 \textit{BUS. LAW.} 1447, 1451 (2004)
\end{itemize}
Congress placed itself directly and undeniably in the corporate governance field by enacting SOX with the goal of enhancing the independent oversight of corporate executives whose misdeeds had undermined investor confidence.\textsuperscript{142}

\textbf{C. Provisions of SOX and SRO Rules Affecting Corporate Governance}

Many SOX provisions increase the oversight responsibilities of boards of directors of public companies acting through their audit committees.\textsuperscript{143} SOX defines an audit committee as a committee formed for the purpose of “overseeing the accounting and financial reporting processes of the issuer and audits of the financial statements of the issuer.”\textsuperscript{144} Perhaps the best example of the duties that SOX places on public company audit committees is the requirement that they be responsible for the appointment, compensation and oversight of external auditors.\textsuperscript{145} Under this rule, the external auditor of every public company must report directly to the audit committee when performing audit and other services, not to management, which traditionally had been the practice. SOX also requires the audit committee to establish procedures for the receipt, retention and treatment of complaints regarding the company’s accounting and auditing practices.\textsuperscript{146} These procedures must include a method for employees to submit confidential, anonymous concerns regarding questionable accounting or auditing

\textsuperscript{142} See \textit{Senate Report}, supra note 134; see also \textit{Fairfax}, supra note 8, at 400 (commenting that SOX was an effort to restore directors’ adherence to their fiduciary duties); Thompson et al., \textit{supra} note 5, at 876 (noting that Congress passed SOX to combat the corporate governance problems seen in the recent corporate crisis). Congress presumably has the power to preempt state law governing internal corporate affairs under the Commerce Clause of Article I, Section 8 of the U.S. Constitution. Kahan et al., \textit{supra} note 7, at 1578.

\textsuperscript{143} Some commentators suggest that SOX does not reform corporate governance, but rather implements best practices, many of which were already being followed. \textit{See}, e.g., Cunningham, \textit{supra} note 138, at 941-42.


matters directly to the audit committee.\footnote{147}

These provisions were aimed at bringing about the audit committee’s active oversight of the external auditor’s audit as well as management’s accounting practices, in an effort to enhance the committee’s ability to monitor and eradicate improper accounting practices.\footnote{148} As part of this duty, the audit committee is tasked with communicating directly with the external auditor concerning not only the audit, but also any accounting or financial matter or concern.\footnote{149} It is presumed that having the external auditor report directly to the audit committee, instead of to management, reduces the risk that the external auditor will agree with management’s accounting practices merely to continue the engagement. That, in turn, is expected to reduce the risk that the auditor will become complacent with management’s accounting practices as a result of a conflict of interest. Having the audit committee be more actively engaged in the audit process also better enables the audit committee to grasp the relevant accounting issues that the corporation faces.

SOX also requires that each public company have an audit committee comprised completely of independent directors.\footnote{150} In its promulgating release, the Commission directed the SROs to adopt rules consistent with this requirement.\footnote{151} As directed, the SROs adopted rules

\footnote{147. \textit{Id.}}

mandating wholly independent audit committees.\footnote{152} Under the corporate governance rules adopted by the NYSE and NASD in conjunction with SOX, the board of each listed company must determine whether a director is independent based on his or her relationship with the company.\footnote{153} Those rules do not, however, leave the finding of independence entirely up to the board. Instead, they specify factors that preclude a finding of independence, including instances where a director: holds an office with a corporation; has any business relationships with the corporation; or receives any compensation from the corporation, other than directors’ fees.\footnote{154} These independence rules also contain look-back periods and affiliate attribution provisions, further expanding their scope.\footnote{155}

The NYSE and NASD also require a majority of the members of the board of each listed company to be independent,\footnote{156} and that those independent directors meet regularly in executive sessions without inside directors present.\footnote{157} Still further, the SROs require each listed company to establish a compensation committee and nominating and governance committee comprised exclusively of independent directors.\footnote{158} These rules are clearly intended to make the board generally, and these committee members in particular, independent from management and other influences that might affect a director’s independent judgment in performing her responsibilities.\footnote{159}

Section 402 of SOX, also aimed at director independence, restricts the ability of directors to receive non-ordinary course loans from the

public companies on whose boards they serve. This provision was intended to address investors’ concerns about loans to insiders, abundant at Enron, and their desire to know about these loans promptly after they are made “in order to better inform their investment decisions.” While that concern may justify a loan disclosure rule, it does not explain SOX’s approach of banning most loans to officers and directors. By enacting this provision, Congress has appeared to plant a corporate governance restriction on public companies rather than cultivating an enhanced system of disclosure, as had been the traditional method that federal securities laws played a part in corporate governance.

It is generally believed that directors failed to detect and prevent many of the recent accounting scandals due to their close ties with management. In the case of the audit committee members, these close ties seemingly impaired their ability to neutrally oversee the audit of financial statements and firm accounting practices. Thus, the intent behind these rules was to eliminate competing personal interests that might compromise an audit committee member’s ability to perform his functions. While mandating independent committee composition

161. Senate Report, supra note 134, at Title IV.D.
162. Many commentators have criticized the overbroad and inflexible nature of Section 402. See, e.g., Brown, supra note 1, at 361; Roe, supra note 9, at 633. For example, Section 402 seems to prohibit a director from receiving an advance of litigation costs, as it is not a permitted exception, though this is permitted under many states’ corporation laws and is generally considered as beneficial to a corporation. See James J. Hanks, Jr., Evaluating Recent State Legislation on Director and Officer Liability Limitation and Indemnification, 43 Bus. Law. 1207, 1226-27 (1998) (noting the states that permit advances of litigation costs). Because of some of the potentially unintended consequences of Section 402, and the lack of Commission guidance on this rule, on October 15, 2002, a group of law firms issued an outline describing loans they considered to be outside of the scope of this section. Alston & Bird LLP et al., Sarbanes-Oxley Act: Interpretive Issues Under 402 – Prohibition of Certain Insider Loans 3-8 (2002), at http://www.realcorporatelawyer.com/pdfs/loan1002.pdf. (last visited Feb. 9, 2007). The outline concludes that advances of litigation costs fall outside of Section 402’s prohibition on loans.
163. Senate Report, supra note 134, at Title III.A; see also Ribstein, supra note 128, at 282.
164. Senate Report, supra note 134, at Title III.A; Leisner, supra note 122, § V-3-4; see also Roel C. Campos, Remarks of SEC Commissioner, 55 Case W. Res. L. Rev.
does not ensure that directors act independently, an independent board process likely flows from having only directors without ties to management performing oversight and decision-making functions. As Commissioner Roel C. Campos has observed, “directors who are supposed to be independent should have the guts to be a pain in the neck and act independently.”

While there are clearly benefits to having independent directors on the board and board committees, there are drawbacks as well. For one, an independent director’s lack of any firm knowledge about a company outside of his role as a director might impair his ability to perform his strategic oversight role. According to a study performed by Professors Sanjai Bhagat and Bernard Black, having a higher percentage of independent directors does not, by itself, improve firm performance. Nonetheless, the presence of independent directors on a board seems to give that board and its committees an appearance of impartiality, an appearance important to restoring investor confidence in the board’s ability to oversee and prevent managerial impropriety in an environment of stockholder skepticism.

527, 529 (2005) (noting that having strong and independent oversight by the board to keep management “in check” is a necessary framework).

165. Campos, supra note 164, at 539.

166. Lynne L. Dallas, The Multiple Roles of Corporate Boards of Directors, 40 SAN DIEGO L. REV. 781, 783-84 (2003) (arguing that inside directors perform the strategic role, focused on developing and implementing corporate strategy, better than outside directors); see Ashby, supra note 33, at 544 (arguing that companies whose boards are composed of a large proportion of independent directors may incur significant information costs to compensate for the independent directors’ lack of communication channels).


168. See Kenneth B. Davis, Jr., Structural Bias, Special Litigation Committees, and the Vagaries of Director Independence, 90 IOWA L. REV. 1305, 1355 (2005) (noting, in the context of a SLC, that among the most important conditions for investors to feel satisfaction from fair treatment is neutrality and the feeling that their fate is in the hands of an unbiased decision-maker who is honest and who uses appropriate factual information to make a decision); Strine, supra note 33, at 1375 (arguing that corporate law has proceeded on the premise that truly independent directors can have a meaningful beneficial influence in ensuring corporate decisions are made impartially and with integrity).

169. A number of commentators have criticized Congress’ failure to include within SOX a change in the process by which directors are nominated. See, e.g., Brown, supra note 1, at 373 (noting that SOX did nothing to alter the director nomination process, and
While SOX emphasizes the importance of having independent directors on the audit committee, it also underscores the need to have a financially educated and experienced audit committee. To that end, SOX requires every public company to disclose whether its audit

that to the extent nominations are controlled or influenced by the CEO, boards are likely to contain independent directors who remain closely aligned with the CEO; Chandler et al., supra note 21, at 999 (noting that the incumbent slates are able to spend their companies’ money in almost an unlimited way to get themselves reelected). The critique has focused on the failure of SOX to remove management’s involvement in the director nomination process. See Chandler et al., supra note 21, at 999. Certainly a nominating committee comprised only of independent directors can be expected to bring about a more independent nomination process than a committee comprised of insiders. However, SOX does not remove management from the nomination process, nor does it open up a company’s proxy statement to stockholder nominees. Ashby, supra note 33, at 543; Strine, supra note 33, at 1377. Thus the risk remains that the incumbent slate will become overly comfortable in its position and become less sensitive to stockholder input. Chandler et al., supra note 21, at 999. The Commission has proposed rules which would require an issuer to include in its proxy statement a director nominee named by long-term stockholders who own a significant amount of stock where the proxy process has been ineffective or stockholders are dissatisfied with that process. See Security Holder Director Nominations, Exchange Act Release No. 34-48626, Investment Company Release No. 26206, to be codified at 17 C.F.R. pts. 240, 249, 274 (proposed Oct. 23, 2003), available at http://www.sec.gov/rules/proposed/34-48626.pdf. But those proposed rules have stagnated due to controversy surrounding their passage. See Summary of Comments: In Response to the Commission’s Proposed Rules Relating to Security Holder Director Nominations, Exchange Act Release No. 34-48626, Investment Company Release No. 26206 (2004), available at http://www.sec.gov/rules/extra/s71403summary.htm (last visited Mar. 2, 2007) (describing the different challenges to the Commission’s proposed rule relating to the security holder director nomination process). A number of activist stockholders have decided to take this bull by the horns, requesting that management include in company proxy statements bylaw amendments which would give stockholders the right to include their director nominees in the company’s annual proxy statements for the election of directors. See e.g. Hewlett-Packard Co., Proxy Statement (Schedule 14A), at 22-23 (Jan. 23, 2007). This trend will likely continue as stockholders are successful at placing their nominees on the board.

170. SENATE REPORT, supra note 134, at Title IV.I (noting that the audit committee’s effectiveness depends, in part, on “its members’ knowledge of and experience in auditing and financial matters”); see Campos, supra note 164, at 533 (“Someone on the audit committee should have enough familiarity in preparing or working with financial statements to be able to probe the financials prepared by management.”).
committee includes a financial expert, and if not, to explain why not.\footnote{171} An audit committee financial expert is generally someone with an understanding of the audit committee’s oversight role and has expertise in accounting matters, as well as an understanding of financial statements.\footnote{172} The Commission’s rules specify how an audit committee member must have acquired that knowledge and expertise.\footnote{173} Both the NYSE and NASD take this concept to the next level, requiring the audit committee of every listed company to contain at least one financial expert, and that all members of the audit committee be, or become, financially literate.\footnote{174}

Enhancing the competence of audit committee members is also clearly intended to improve the ability of the committee to oversee the audit and preparation of financial statements. A director with substantial accounting and financial experience is presumed to be better able to recognize accounting manipulations and spot other accounting and financial issues quicker than directors without that experience.\footnote{175} Still, 


174. See NASDAQ Manual, supra note 152, § 4350 (d)(2)(A) (requiring that each audit committee member be able to read and understand fundamental financial statements); commentary to NYSE Manual, supra note 152, § 303A.07(a) (requiring that each member of the audit committee be financially literate, or become financially literate, within a reasonable period of time after his or her appointment to the audit committee).

175. See Campos, supra note 164, at 533; see also supra note 170 and accompanying text.
these rules do not require the audit committee financial expert to have any special involvement in performing the audit committee’s oversight function. While it stands to reason that a director with special expertise will use that expertise in furtherance of his board duties, SOX does not dictate heightened involvement. As Part IV shows, however, a director’s expertise appears to be increasingly important in the fiduciary duty context.

In addition to tasking the audit committee with oversight of accounting and financial matters, SOX charges the audit committee with receiving and addressing complaints from external counsel regarding material violations of securities laws or fiduciary duties involving the corporation or its directors and officers.176 Under this rule, an external counsel’s complaint must initially be reported to, and investigated by, a firm’s chief legal counsel, or a qualified legal compliance committee (QLCC) comprised of at least one member of the audit committee and other independent directors.177 If the chief legal counsel decides to investigate the complaint but does not take action satisfactory to external counsel to address that complaint, external counsel is required to report its complaint “up the ladder” to the audit committee.178 Consequently, despite any lack of legal expertise, the audit committee members, or QLCC members, may need to decide what action to take to address an alleged violation of securities laws or fiduciary duties reported to them, while doing so in compliance with their own fiduciary duties.

The provisions of SOX discussed above are those that seem to fall squarely within the field of corporate governance. Section 404, however, targeted principally at improving the quality of financial reporting,179 plays an equally important role in defining the duties of directors. Section 404 focuses on “internal controls over financial reporting,” referring to the process that a corporation uses to assure the reliability of its financial reporting and the preparation of its financial statements based on the risks facing the company.180 Internal control

178. See id.
179. Hamilton & Rasmussen, supra note 149, at 11.
systems pervade every corporate enterprise, and include systems designed to provide assurances as to the effectiveness and efficiency of operations, reliability of financial reporting and compliance with law.\textsuperscript{181} Section 404 and the implementing release require each public company to include in its annual report a statement that management is responsible for establishing and maintaining adequate internal controls over financial reporting, along with management’s assessment of the effectiveness of those controls.\textsuperscript{182} The company’s external auditor must then attest to, and report on, management’s assessment.\textsuperscript{183}

This requirement to establish internal control systems is not new.\textsuperscript{184} But by requiring that management assess the effectiveness of those controls, and that the auditor attest to that assessment, SOX significantly

\textsuperscript{181} See Section 404 Release, \textit{supra} note 180; see also Hamilton & Rasmussen, \textit{supra} note 149, at 19 (noting that internal controls extend to “policies, plans, procedures, processes, systems, activities, functions, projects, initiatives and endeavors of all types at all levels of a company”).

\textsuperscript{182} Sarbanes-Oxley Act § 404, 116 Stat. at 789 (codified at 15 U.S.C. § 7262); Section 404 Release, \textit{supra} note 180. Each public company must file an annual report at the end of each fiscal year and a quarterly report at the end of each other fiscal quarter. \textit{See} 15 U.S.C. §§ 78m(a), 78o(d) (codified at Sections 13(a) and 15(d) of the Exchange Act).


expands the level and scope of diligence required by both management and auditor, as to internal controls. This is a much more time-consuming and costly endeavor than the more superficial testing auditors performed prior to SOX in order to deliver their audit reports.  

While a complete understanding of Section 404 necessitates an understanding of complex accounting rules and standards, the implication for audit committees is clear: while management is tasked with creating and assessing a public company’s internal controls based on the risks that company faces, the audit committee must oversee the design and operation of those internal controls and ensure their effectiveness. Further, the audit committee must oversee the remediation of any internal control deficiencies. As Commissioner Campos poignantly noted, presumably based on this internal controls requirement, “[a]udit committees and independent directors must take more affirmative roles in rooting out accounting and internal control issues.”

Other SOX provisions seem to have more lofty goals. Specifically, SOX and the Commission’s implementing rules require that each public company disclose whether or not it has adopted a code of ethics covering the conduct of its principal financial officers, principal accounting officers and principal executive officer and if not, explain why not. Generally, a code of ethics must specify standards reasonably designed to deter wrongdoing and be designed to promote honest and ethical conduct, avoidance of conflicts of interest, compliance with laws, and inclusion of full, fair and timely disclosure in reports filed with the Commission. Expanding on this notion, the NYSE and NASD have adopted corporate governance rules requiring listed companies to adopt codes of ethics covering their directors, officers and employees. While public companies without a listed

186. Leisner, supra note 122, § I-67 n.141; Hamilton & Rasmussen, supra note 149, at 13.
187. Campos, supra note 164, at 537.
190. See NASDAQ Manual, supra note 152, § 4350(n); NYSE Manual, supra note
class of securities are not bound by these SRO rules, it is presumed that they will decide to adopt a code rather than having to explain why they did not. 191

According to the Senate Committee on Banking, Housing, and Urban Affairs, the rationale for the code of ethics rule was to inform investors as to whether a company “holds its financial officers to certain ethical standards in their financial dealings.” 192 Yet by requiring that a code of ethics also apply to the chief executive officer and in the case of a listed company, to employees, the Commission and SROs appear to be striving to have “the focus on doing the right thing become part of the DNA of a company and everyone in the company from top to bottom.” 193 The SROs have attempted to impose board oversight over compliance with ethics codes by requiring board approval of waivers for directors and executive officers. 194

D. SOX and SRO Rules Step into the Ring with Fiduciary Duties

For companies subject to the Reform, this patchwork of corporate governance requirements has been superimposed on top of the existing corporate governance framework, creating a bundle of outside director responsibilities and qualifications aimed at enhancing the boards’ ability to oversee corporate insiders and corporate information-gathering systems. 195 But the Reform neither expressly supplants state law, nor sets forth an overall scheme of corporate governance. 196 Thus state law

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191. See Leisner, supra note 122, § III-4-4 (arguing that it is hard to imagine a public company offering a reasonable explanation for not adopting a code of ethics).
192. See SENATE REPORT, supra note 134, at Title IV.H.
193. See Hamilton et al., supra note 2, at 22 (referring to the report to the U.S. District Court for the Southern District of New York on Corporate Governance for the future of MCI, Inc., commonly referred to as the Breeden Report (2003)).
194. See NASDAQ Manual, supra note 152, § 4350(n); commentary to NYSE Manual, supra note 152, § 303A.10.
195. See Johnson et al., supra note 6, at 1209 (“The new federal rules largely accept as given state law’s structural allocation of decision-making responsibility within corporations.”).
196. See Brown, supra note 1, at 320 (arguing that SOX was a reaction to specific problems arising out of the corporate governance scandals and not a mechanism to fill systematically the void created by the lack of meaningful standards at the state level); Chandler et al., supra note 21, at 982 (noting that the Reform does not constitute a comprehensive body of substantive corporation law); Johnson et al., supra note 6, at
appears to have retained its role as the principal fabric of which the corporate governance framework is made. Moreover, neither SOX nor the SROs’ listing standards create a mechanism for private enforcement of their corporate governance mandates. Instead, any private right of enforcement of these mandates exists solely under state law.

Have Delaware courts been responding to stockholder calls for enforcement of the Reform’s corporate governance mandates? It is difficult to tell because Delaware courts must wait for cases to come before they can create case law reflecting a shift in corporate governance standards. Moreover, because of their adherence to the doctrine of stare decisis, Delaware courts often try to reconcile their decisions with existing case law rather than making clear pronouncements of new law. Nevertheless, several recent court decisions suggest the Delaware courts are increasingly focused on directors’ performance of
their oversight function without undue influence by insiders. This might be a good indication that the Delaware courts are beginning to reexamine the duties of directors in the current corporate climate. This evolution in fiduciary duties is explored in Part IV.

IV. DELAWARE FIDUCIARY DUTIES TAKE CENTER STAGE, AGAINST THE BACKDROP OF THE REFORM

While the Reform affects a number of significant corporate governance changes, it does not apply to all boards. Most SOX provisions only apply to public companies. Further, the SROs’ governance listing standards only apply to companies listing securities on those exchanges. Although not required to do so by SOX or the SRO listing standards, private companies have also been implementing corporate governance practices consistent with the Reform. There are a number of reasons for this phenomenon. First, many private companies are being pushed into compliance by their auditors, their

202. See discussion infra Part IV; see also Jones, supra note 9, at 645, 662 (noting a trend toward stricter judicial decision-making).

203. See Jones, supra note 9, at 662 (noting that a fundamental shift in Delaware corporate jurisprudence seems to have occurred).

204. See discussion supra Part III.B.

205. See id.

206. Leisner, supra note 122, § II-8-33 to -34. According to a study performed by the law firm Foley & Lardner LLP, nearly 85% of the participating private companies said that they were complying with some aspects of SOX. Foley & Lardner, THE IMPACT OF SARBANES-OXLEY ON PRIVATE & NONPROFIT COMPANIES (2006) available at http://www.foley.com/files/tbl_s31Publications/FileUpload/137/3511/ndi%202006%20private%20study.pdf [hereinafter Foley & Lardner Study]. Very few private companies have complied with the requirement to obtain an auditor attestation on their internal controls because of the costs associated with compliance. Id.; see Joseph Castelluccio III, Sarbanes-Oxley and Small Business: Section 404 and the Case for a Small Business Exemption, 71 BROOK. L. REV. 429, 456-59 (2005) (discussing the costly and burdensome effect on small companies of complying with Section 404 of SOX); Nathan Wilda, Comment, David Pays for Goliath’s Mistakes: The Costly Effect Sarbanes-Oxley Has on Small Companies, 38 J. MARSHALL L. REV. 671, 682-83 (2004) (noting the difficulties involved for smaller companies to comply with the internal controls requirements); Susan Greco, What They Do in Private (Private Companies Adopting Sarbanes-Oxley Act), CORP. COUNS., Sept. 2005, at 24. As the general counsel of Cargill Incorporated, the largest private company in the U.S., aptly noted in connection with the auditor attestation requirement under SOX Section 404, private companies “continue to have the luxury to be pragmatic.” Id.
lenders, or their public company vendors or customers. In addition, any private company seeking to go public, or to be acquired by a public company, might elect to comply with the Reform in order to appear more attractive to investors or potential acquirers. But those reasons alone do not seem to explain the widespread adoption of Reform-like corporate governance practices by private companies. As the following cases suggest, an impetus for complying with reformed corporate governance practices appears to be coming from a shift in Delaware jurisprudence as to the parameters of fiduciary duties, and how directors satisfy those duties following the Reform.

A. Good Faith and the Duties of Care and Loyalty Revisited Post-Reform

I. Disney

Following the death of the Walt Disney Company’s president in a tragic helicopter crash, Disney Chairman and CEO Michael Eisner decided to recruit long-time friend Michael Ovitz, the founder of a successful talent agency, for the position. Eisner, together with Irwin Russell, a director and the chairman of Disney’s compensation committee, were eventually able to persuade Ovitz to accept the position. After negotiating with Ovitz, Eisner and Russell agreed to include in Ovitz’s employment agreement a significant no-fault termination payment to protect Ovitz in the event that the employment

207. Greco, supra note 209, at 24.

208. Leisner, supra note 122, § II-8-33; Matt Murray, Private Companies Also Feel Pressure to Clean Up Acts, WALL ST. J., July 22, 2003, at B1. In addition, some D&O insurance providers are either not providing coverage or are providing more expensive coverage to companies which are not SOX-compliant, providing a further impetus to comply. Leisner, supra note 122, § II-8-34.

209. See supra note 206 and accompanying text.

210. Several commentators have suggested that this shift in Delaware jurisprudence is Delaware’s attempt to stave off further federal intervention in the area of corporate governance. See, e.g., Jones, supra note 9, at 626, 633-36; Note, The Case for Federal Threats in Corporate Governance, 118 HARV. L. REV. 2726, 2745, 2747 (2005).


212. Id. at *20, 31-47.
relationship did not work out.\textsuperscript{213} Disney retained an executive compensation consultant to evaluate the financial terms of Ovitz’s employment agreement.\textsuperscript{214} Raymond Watson, another member of the compensation committee, also evaluated those terms.\textsuperscript{215} When the compensation committee members met to discuss the proposed terms of Ovitz’s employment agreement, they were given Watson’s analysis on the value of the employment agreement as well as a term sheet.\textsuperscript{216} They did not, however, review either a draft of the employment agreement or the external consultant’s report.\textsuperscript{217} The compensation committee unanimously approved the terms of the employment agreement at that meeting, and the board thereafter unanimously elected Ovitz as president.\textsuperscript{218} Ovitz took over as president on October 1, 1995.\textsuperscript{219} But within a year, it became clear that Ovitz was not a good fit at Disney.\textsuperscript{220} At Eisner’s request, Disney’s general counsel reviewed Ovitz’s employment agreement and determined that if Disney were to terminate Ovitz’s employment, it would constitute a no-fault termination.\textsuperscript{221} At the next executive session of independent directors, Eisner informed the directors of his intention to terminate Ovitz’s employment.\textsuperscript{222} The directors were not asked to, nor did they, approve the termination.\textsuperscript{223} The no-fault termination payment paid to Ovitz upon his termination amounted to $130 million.\textsuperscript{224}

Several Disney stockholders sued the board and Ovitz for breaches of their fiduciary duties for entering into the employment agreement with Ovitz and terminating that employment without fault.\textsuperscript{225} The Delaware Chancery Court found that the facts, if true, portrayed

\begin{footnotesize}
\begin{enumerate}
\item \textsuperscript{213} \textit{Id.} at *20-24.
\item \textsuperscript{214} \textit{Id.} at *25-26.
\item \textsuperscript{215} \textit{Id.} at *26-27.
\item \textsuperscript{216} \textit{Id.} at *39.
\item \textsuperscript{217} \textit{Id.}
\item \textsuperscript{218} \textit{Id.} at *40, 43.
\item \textsuperscript{219} \textit{Id.} at *47.
\item \textsuperscript{220} \textit{Id.} at *54-55.
\item \textsuperscript{221} \textit{Id.} at *99-101.
\item \textsuperscript{222} \textit{Id.} at *105.
\item \textsuperscript{223} \textit{Id.} at *122-23.
\item \textsuperscript{224} \textit{In re} Walt Disney Co. Derivative Litig. (Disney V), C.A. No. 15452, 2006 Del. LEXIS 307, at *3 (Del. 2006).
\item \textsuperscript{225} \textit{Disney I,} 731 A.2d at 351, \textit{aff’d in part, rev’d in part sub nom.} Brehm v. Eisner, 746 A.2d 244 (Del. 2000).
\end{enumerate}
\end{footnotesize}
directors who “consciously and intentionally disregarded their responsibilities, adopting a ‘we don’t care about the risks’ attitude concerning a material corporate decision.”

Thus, the facts called into question whether the board had acted in good faith, and whether the plaintiffs’ failure to make demand on the board was excused.

The primary question at trial was whether the Disney directors breached their duty of care or duty to act in good faith. Consistent with some recent decisions, but in a break from traditional duty of care analyses, the Chancery Court analyzed the plaintiffs’ claims against the directors on a director-by-director basis “because the nature of their breach of duty (if any), and whether they are exculpated from liability for that breach, can vary for each director.”

The Chancery Court first reviewed the duty of care, repeating the standard that in making a business decision, a director must consider all material information reasonably available, and will only be found to have breached the duty of care where his failure to be informed amounts to gross negligence. Outside of the context of a board decision, a director will be found to have breached his duty of care where a plaintiff shows a “lack of good faith as evidenced by [sic] sustained or systematic failure of a director to exercise reasonable oversight.”

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227. Id. After Disney II, Ovitz moved for summary judgment after discovery, arguing that he did not owe the Disney stockholders a fiduciary duty at the time he negotiated and entered into his employment agreement, nor at the time he received his severance payment. In re Walt Disney Co. Derivative Litig. (Disney III), 2004 LEXIS 132, at *2-3 (Del. Ch. 2004). The Chancery Court agreed that Ovitz was not a fiduciary at the time he negotiated his employment agreement. Id. at *28. However, the court found reasonable doubt as to whether Ovitz had breached his fiduciary duty in obtaining the no-fault termination payment and thus did not dismiss that claim. Id. at *34-35.
228. In re Walt Disney Co. Derivative Litig. (Disney IV), 2005 Del. Ch. LEXIS 113, at *148, aff’d C.A. No. 15452, 2006 Del. LEXIS 307 (Del. 2006). The duty of loyalty claim only pertained to Ovitz and the court resolved that claim by determining that Ovitz did not play any part in the decision to fire himself or to pay himself the no-fault termination payment. Id. at *183. The court also dismissed the waste claim as it found that the record did not support a finding of waste given the high hurdle needed to show waste. Id. at *186-89.
229. Id. at *154 (citing In re Emerging Communications Inc. S’holders Litig., 2004 Del. Ch. LEXIS 70, 2004 WL 1305745, at *38 (Del. Ch. 2004)).
230. Id. at *158-63.
231. Id. at *161 (citing In re Caremark Int’l Inc. Derivative Litig., 698 A.2d at 971).
Next, the court analyzed the duty of good faith. The Chancery Court acknowledged that Delaware court decisions have not been entirely clear or consistent as to whether a separate duty of good faith exists, or in fact what good faith means.\textsuperscript{232} In the Chancery Court’s view, good faith mandates not only compliance with a director’s duties of care and loyalty, but also that she act with an honesty of purpose.\textsuperscript{233} According to the court, one standard of bad faith is the “intentional
dereliction of duty, a conscious disregard for one’s responsibilities.”\textsuperscript{234} An action taken with intent to harm a corporation, such as authorizing a transaction either for some purpose other than a genuine attempt to advance corporate welfare, or one violating the law, also amounts to bad faith.\textsuperscript{235} But the court noted that these are not the only definitions of bad faith.\textsuperscript{236}

Based on the facts presented, the Chancery Court found that none of the Disney directors breached their duty of care or duty to act in good faith. Specifically, the court found that each of the board members was informed as to all material information reasonably available in hiring Ovitz.\textsuperscript{237} The court noted that the board’s conduct fell short of best practices, particularly Eisner’s failure to keep the full board informed during the hiring process.\textsuperscript{238} But in the court’s view, these deficiencies did not amount to gross negligence, nor were they taken with intent to harm Disney or with an intentional and conscious disregard of duty.\textsuperscript{239} Further, the compensation committee members did not breach their duties of care or good faith in negotiating and approving Ovitz’s compensation package.\textsuperscript{240} While the court acknowledged that the lack of involvement of some committee members hearkens back to the lapses seen in \textit{Van Gorkom}, the court distinguished the board’s decision as to executive compensation in \textit{Disney} from the “monumental” decision in \textit{Van Gorkom} to sell a company.\textsuperscript{241} With respect to the fiduciary duty

\begin{itemize}
\item \textsuperscript{232} \textit{Id.} at *169.
\item \textsuperscript{233} \textit{Id.} at *169-70.
\item \textsuperscript{234} \textit{Id.} at *175 (italics in original).
\item \textsuperscript{235} \textit{Id.} at *169-70.
\item \textsuperscript{236} \textit{Id.} at *175.
\item \textsuperscript{237} \textit{Id.} at *198, 227.
\item \textsuperscript{238} \textit{Id.} at *198-99.
\item \textsuperscript{239} \textit{Id.} at *200.
\item \textsuperscript{240} \textit{Id.} at *205-24.
\item \textsuperscript{241} \textit{Id.} at *212. The Chancery Court also distinguished \textit{Disney} on other grounds, including the fact that board approval is not required under the DGCL for the retention
claims relating to the termination of Ovitz, the Chancery Court found
that Eisner had the power to remove inferior officers and employees
under Disney’s organizational documents and related board
authorization.\textsuperscript{242} Thus, no board action was required to terminate Ovitz,
and no fiduciary duty was breached as a result of that action.\textsuperscript{243}

The Delaware Supreme Court affirmed the Chancery Court’s
ruling.\textsuperscript{244} Further crystallizing what amounts to bad faith, and consistent
with the lower court’s decision, the court ruled that “subjective bad
faith,” or conduct motivated by an actual intent to do harm, can
constitute bad faith.\textsuperscript{245} The court stated that this construction is “so well
accepted in the liturgy of fiduciary law that it borders on axiomatic.”\textsuperscript{246}
Another category of bad faith “involves” the lack of due care, or gross
negligence.\textsuperscript{247} However, gross negligence alone does not constitute bad
faith.\textsuperscript{248} The court explained the distinction between gross negligence
and bad faith by way of example.\textsuperscript{249} Specifically, where a director has
subjective hostility to a corporation on whose board he serves and thus
fails to inform himself or to devote sufficient attention to matters as to
which he is making a decision, the subjective hostility would lead to a

\begin{itemize}
\item \textsuperscript{242} Id. at *212-14.
\item \textsuperscript{243} Id. at *232-33.
\item \textsuperscript{244} Id. at *232-35.
\item \textsuperscript{245} \textit{In re} Walt Disney Co. Derivative Litig. (Disney V), C.A. No. 15452, 2006 Del.
LEXIS 307, at *126 (Del. 2006).
\item \textsuperscript{246} Id. at *93.
\item \textsuperscript{247} Id. at *94. This type of bad faith is referred to herein as “gross negligence
plus” because it requires a showing of gross negligence \textit{plus} some evidence of a bad
intent, though it is not clear how bad this bad intent must be, or how it is to be
established.
\item \textsuperscript{248} Id. at *94-95. The Delaware Supreme Court referred to Sections 102(b)(7) and
145 of the DGCL, which disallow exculpation and indemnification, respectively, of
directors for actions not taken in good faith, to evidence the Delaware General
Assembly’s intent to distinguish the duty of care from the duty of good faith. Id. at
*96-98.
\item \textsuperscript{249} Id. at *95.
\end{itemize}
finding of bad faith, while the gross negligence would lead to a finding of the breach of the duty of care. According to the court, this formulation of bad faith is intended to capture conduct not involving classic disloyalty, but that is qualitatively more culpable than gross negligence. Parroting words from Chancellor Chandler, the court indicated that other definitions of bad faith may exist.

Disney, (referring collectively to Disney IV and Disney V), seems to reflect a shift in Delaware jurisprudence regarding fiduciary duties. Prior to Disney, Delaware courts did not typically undertake a separate analysis as to whether directors acted in good faith, suggesting that good faith is assuming independent significance in the fiduciary duty context.
only because the failure to act in good faith affords courts an avenue to potentially impose liability not exculpated under Section 102(b)(7) of the DGCL, but it also could impose liability for which directors might not be insured.255

Members of the Delaware judiciary predicted—or perhaps more appropriately, warned—that the Delaware courts would be willing to use the notion of good faith as a way to respond to stockholder calls for post-Reform enforcement of enhanced director duties.256 As suggested

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255. Jeffrey D. Hern, Delaware Courts’ Delicate Response to the Corporate Governance Scandals of 2001 and 2002: Heightened Judicial Scrutiny on Directors of Corporations, 41 WILLIAMETTE L. REV. 207, 220-21 (2005) (suggesting that Disney evidences a heightening of judicial scrutiny on directors and a toughening of corporate governance standards in Delaware). D&O liability insurance policies generally do not provide coverage for deliberate fraud or personal profit or advantage obtained wrongfully. Black, supra note 3, at 1086. While not all bad faith would fit within these policy exclusions, because bad faith is considered indirectly a breach of the duty of loyalty, presumably insurers will use a breach of the duty of loyalty to show that an improper personal benefit was obtained and deny coverage.

256. Strine, supra note 33, at 1393 (noting how plaintiffs’ lawyers might approach “duty to monitor” cases after Enron); Veasey, Access to Justice, supra note 254, at 13 (“Today, the utter failure of directors to follow the minimum expectations of the standards of directors conduct, Sarbanes-Oxley, or the NYSE or NASDAQ Rules, might likewise raise a good faith issue.”); see also Johnson & Sides, supra note 6, at 1152 (predicting that the duty of good faith will likely be a doctrinal vessel for injecting certain mandates of SOX into state fiduciary duty law). It is not surprising that the Delaware courts decided to reveal the new direction of the courts in the executive compensation context, given the absence at that time of any measure to curb executive compensation in the Reform, and the role options are thought to have played in bringing about accounting fraud. See supra notes 128-31 and accompanying text. In August of 2006, the Commission passed rules requiring significant new disclosure as to executive compensation in an easier-to-understand format. Executive Compensation and Related Person Disclosure, 17 C.F.R. pts. 228, 229, 232, 239, 240, 245, 249 and 274 (2006), available at http://www.sec.gov/rules/final/2006/33-8732a.pdf (last visited Mar. 2, 2007). In its adopting release, the Commission emphasized the association between compensation and relationships with the issuer, as transactions often involve compensation-like features. Id. Thus the disclosure is aimed at providing investors with information about potentially independence-compromising compensation arrangements. Id.
by Vice Chancellors Chandler and Strine, the Delaware courts appear to have become more receptive to stockholder arguments for increased accountability to enforce responsibilities under the Reform, seen largely as an effort to align state law with federal law.\textsuperscript{257} That Delaware courts will, on some level, implement the Reform’s call for increased director oversight is fortunate for stockholders, who presumably will seek to enforce duties imposed under the Reform through state fiduciary duty law, due to the absence of an enforcement avenue through the federal courts.\textsuperscript{258} In that way, even though federal securities law and Delaware law take contrasting approaches to regulating director conduct (the former regulating by proscriptive rules and the latter regulating by enabling standards) both seem to reflect the evolving environment of enhanced directors’ oversight duties and increased accountability.\textsuperscript{259}

2. Stone

Following \textit{Disney}, it was not entirely clear whether there was a separate fiduciary duty of good faith, though it was evident both that the Delaware courts were placing a new emphasis on the obligation of a director to act in good faith, and that liability could flow from failing to act in good faith. One of the possible implications of there being a separate duty of good faith is that it could create a basis for director liability beyond the traditional bounds of the duties of care and loyalty. However, in \textit{Stone v. Ritter}\textsuperscript{260} it became clear that good faith was not a separate fiduciary duty, but rather a component of the duty of loyalty.

In \textit{Stone}, AmSouth Bancorporation paid $50 million in fines and penalties as a result of a number of failures by bank employees to file Suspicious Activity Reports (SARs) with a bureau of the U.S. Department of Treasury.\textsuperscript{261} Under federal bank secrecy and anti-
money-laundering laws, SARs must be filed where a bank knows or has reason to suspect that a banking transaction involves funds derived from illegal activities. Several stockholders of AmSouth filed a derivative suit against AmSouth’s directors, alleging that the directors breached their fiduciary duties by failing to institute sufficient internal controls to prevent violations of bank secrecy and anti-money-laundering laws. The Delaware Chancery Court granted the defendant directors’ motion to dismiss for failure to make demand on the board, and the Delaware Supreme Court affirmed. Applying the second prong of the Rales test for when demand is excused outside of the context of a business decision, the court analyzed whether the complaint created a reasonable doubt that the board could have properly exercised its independent and disinterested business judgment in responding to demand. That, in turn, depends on whether the directors face a substantial likelihood of liability for which they would not be exculpated under Section 102(b)(7) of the DGCL. Because the plaintiffs did not allege a breach of the duty of loyalty, the court analyzed whether the directors had acted in bad faith, which also precludes exculpation under Section 102(b)(7).

The Delaware Supreme Court validated the definition of bad faith in the oversight context set forth in Caremark, which defined bad faith as a “sustained or systematic failure of the board to exercise oversight—such as an utter failure to attempt to assure a reasonable information and reporting system exists . . . .” According to the court, this definition is consistent with the Disney definition of bad faith as a conscious disregard for duties. Thus a conscious failure to monitor or oversee the operation of a reporting or information system would amount to bad faith. However, the failure to act in good faith does not ipso facto result in fiduciary liability. Rather, bad faith is a “condition” of the

262.  Id. at 365 n.4.
264.  Id. at *8.
265.  Id. at 367.
266.  Id.
267.  Id.
268.  Id.
269.  Id. at 369 (citing In re Caremark Int’l Inc. Deriv. Litig., 698 A.2d at 971).
270.  Id.
271.  Id. at 370.
272.  Id. at 369.
duty of loyalty which “may” lead to a breach of the duty of loyalty.\textsuperscript{273} Thus according to the court, there is no separate duty of good faith, but rather a good faith component to the duty of loyalty which, if not satisfied, may lead to a breach of the duty of loyalty. Based on the facts, including a report prepared by an independent consultant which found that AmSouth’s board had at various times enacted written policies and procedures designed to ensure compliance with bank secrecy and anti-money-laundering laws, the court held that the plaintiffs had not created a reasonable doubt as to whether the directors acted in good faith.\textsuperscript{274}

Even following \textit{Disney} and \textit{Stone}, the path to enforcement of the duty of loyalty through the failure to act in good faith is not entirely clear, in part due to the paucity of case law on good faith as a component of the duty of loyalty, and in part because of the suggestion by the courts in \textit{Disney} that definitions of bad faith other than those that have been enumerated might exist.\textsuperscript{275} The difficulty in knowing what amounts to bad faith is compounded by the Delaware Supreme Court’s statement that although fiduciary duties do not change over time, “how we understand those duties may evolve and become refined.”\textsuperscript{276} How we understand fiduciary duties indeed appears to be shifting, evidenced by the careful scrutiny given to the process employed by the Disney compensation committee in making an ordinary business decision that, before \textit{Disney}, seemed to have been presumed a valid exercise of business judgment. Just as a defined word takes on a new or altered meaning to reflect societal and linguistic changes, so too do fiduciary duties morph as stockholders’ and courts’ expectations and demands change with the currents of business and policy.\textsuperscript{277}

\textsuperscript{273} \textit{Id.} at 369-70.
\textsuperscript{274} \textit{Id.} at 373.
\textsuperscript{275} \textit{See supra} note 252; \textit{but see} Janssen \textit{supra} note 25 at 1608-09 (noting that the court in \textit{Disney V} focused on board procedure rather than on the irrationality of a board decision in defining good faith, thus making it a weak duty).
\textsuperscript{276} \textit{In re} Walt Disney Co. Derivative Litig. (Disney IV), 2005 Del. Ch. LEXIS 113, at *4, aff’d C.A. No. 15452, 2006 Del. LEXIS 307 (Del. 2006). As former Chief Justice Veasey has indicated, “In my view, what we are seeing as our jurisprudence develops are the ‘evolving expectations of directors.’” Veasey, \textit{Counseling Directors}, \textit{supra} note 141, at 1450; \textit{but see} Janssen, \textit{supra} note 25, at 1602 (noting, after \textit{Disney IV} was decided, that \textit{Disney IV} greatly restricted the duty of good faith and thereby limited the ability of Delaware courts to apply the duty of good faith to enhance director accountability).
\textsuperscript{277} \textit{See} Janssen, \textit{supra} note 25, at 1598-1600; \textit{see also supra} note 269 and
In addition to the evolution of fiduciary duties reflecting changing expectations, fiduciary duties change where “fulfilling a fiduciary duty requires obedience to other positive law.”\textsuperscript{278} This is important in the wake of the Reform, as audit committee directors have a number of new responsibilities under SOX aimed at making them more involved in overseeing management accounting practices, the audit itself and compliance with law.\textsuperscript{279}

\textit{Disney} and \textit{Stone} are significant in an environment following recent lapses in board oversight that led to corporate collapses on a grand scale, where directors’ performance of their monitoring function has been placed under a microscope. \textit{Disney} suggests that a court might closely scrutinize an ordinary business decision to determine whether lapses in the decision-making process amounted to a conscious disregard for responsibilities, “gross negligence plus” or some other as-of-yet undefined form of bad faith. With oversight responsibilities imposed by the Reform, and as a result of the broad standardization of Reform-like governance practices, directors will undoubtedly face an increased number of ordinary business decisions requiring them to take into account all information reasonably available to them, using a process indicating good faith.

\textit{Stone}, on the other hand, demonstrates how courts might implement the Reform’s enhanced internal control system requirements through fiduciary duty law,\textsuperscript{280} as the court makes clear that internal controls are

\begin{footnotesize}
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\item \textsuperscript{278} Disney IV, 2005 Del. Ch. LEXIS 113, at *4.
\item \textsuperscript{279} See Hamilton & Rasmussen, supra note 149, at 13 (discussing the impact of Section 404 of SOX on audit committees); Leisner, supra note 122, § I-144 to -54 (discussing all of the new responsibilities of audit committee members under SOX); see also discussion supra Part III.C.
\item \textsuperscript{280} See Chandler, et al., supra note 21, at 987. (“[T]he gravitational effect of the Reform’s existence will nudge state judges to align their own state corporate systems to avoid whipsawing corporate directors with incompatible dictates.”); Strine, supra note 33, at 1385; see also supra note 256 and accompanying text. According to former Chief Justice Veasey:

I would note, also as a matter of prudent counseling, that boards should be told that it is arguable—but not settled—that their conduct may be measured not only by the evolving expectations of directors in the context of Delaware common law fiduciary duty, but also it may well be measured against the backdrop of relevant Sarbanes-Oxley SEC Rules and the SRO requirements, even though there may be no express private right of action in the federal legislation. That is, when and if these reforms are
\end{itemize}
\end{footnotesize}
part of the information and reporting systems that directors must assure exist under Caremark.\textsuperscript{281} It also instructs plaintiffs how to make a case against directors in relation to their deficient implementation or oversight of internal controls. This is consistent with the message conveyed by Vice Chancellor Strine:

Enron will also generate increased pressure on courts to examine carefully the plausibility of directors’ claims that they were able to devote sufficient time to their duties to have carried them out in good faith . . . . Enron and situations like it suggest to me that skillful plaintiffs’ lawyers will begin making common-sense arguments about the disconnect between the routine tasks directors undertook to perform and the effort they put in to accomplish them.\textsuperscript{282}

Private companies have also been putting enhanced information and reporting systems in place, suggesting that these systems are becoming the norm.\textsuperscript{283} In the context of public companies, stockholders are unable to enforce the implementation of Reform-compliant internal control systems under federal securities laws. This may lead to further attempts to enforce those internal control requirements under state fiduciary duty law, using arguments similar to those made in Stone. Enhanced information and reporting systems seem to lead to an enhanced duty of oversight, not only as part of an obligation to oversee implementation and functioning of those internal control systems, but also due to the need to use the information generated by those systems in the discharge of duties.\textsuperscript{284} For instance, deficiencies in internal controls

\begin{quote}
Veasey, Counseling Directors, supra note 141, at 1453.
282 Strine, supra note 33, at 1385 (italics in original).
283 Foley & Lardner Study, supra note 206 (finding that close to 70% of the responding private companies indicated that they had, or intended to, increase the internal audit function, and close to 60% indicated that they had or intended to have an outside audit of internal financial controls); see Johnson et al., supra note 6, at 1216 (arguing that SOX might impose a federal mandate of adopting reasonable controls as a state standard, since this appears to be consistent with Caremark).
284 See Fairfax, supra note 8, at 401-02 (arguing that SOX requires audit committee members to remain informed about accounting and financial processes and to ask probing questions about those processes and to be involved with internal investigations arising from information and reporting systems); Johnson, supra note 6,
\end{quote}
may keep the audit committee from receiving the information it needs—and is expected to have—in monitoring firm performance. As a result, the audit committee might not be able to oversee the accounting and financial reporting processes effectively, a responsibility it is charged with. Disney and Stone do not provide an exclusive list of actions that amount to bad faith. Thus, the audit committee might face accusations that its failure to consider information not reported to it due to information and reporting system deficiencies prevented it from acting in the best interests of stockholders. The fact that public companies are required to disclose any internal control deficiencies might give plaintiffs the ace in establishing this type of fiduciary duty claim.

On the heels of the Reform’s change to the corporate governance framework, the U.S. sentencing commission amended the organizational sentencing guidelines for the first time, strengthening the criteria for an effective compliance program. Under the amended guidelines, courts can consider the fact that directors and officers oversaw the operation of a compliance and ethics program a mitigating factor in determining the punishment for an organization found to have engaged in criminal conduct. The U.S. sentencing commission’s inclusion of ethics in the compliance program is new; previous guidelines only contemplated programs to detect and prevent violations of law. As former Chancellor Allen noted in reference to organizational sentencing guidelines in Caremark, “[a]ny rational person attempting in good faith to meet an organizational governance responsibility would be bound to take into account this development and the enhanced penalties and the

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285. See Strine, supra note 33, at 1393, noting: One can see how plaintiffs’ lawyers might approach “duty to monitor” cases differently in the near future. They might well ask courts to infer not only that the audit committee members did not know enough about their company’s financial and accounting practices, but also that the committee members knew that their inadequate knowledge disabled them from discharging their responsibilities with fidelity.


287. Id.

288. Id.
opportunities for reduced sanctions that it offers.\textsuperscript{289} In heeding former Chancellor Allen’s remarks, a board may need to implement a corporate compliance and ethics program to comply with its fiduciary duty of oversight in good faith.\textsuperscript{290} Here, again, the federal mandate can be heard: corporate players must play by the rules and be upstanding to boot.

3. Emerging Communications

While the Delaware courts upheld the compensation committee’s reliance on a report prepared by Disney’s compensation consultant, the Delaware Chancery Court in another post-Reform decision found that one of the directors was not so entitled to rely.\textsuperscript{291} In \textit{In re Emerging Communications Inc. Shareholders Litigation}, Jeffrey Prosser owned all shares of Innovative Communications, which in turn owned a majority of the shares in Emerging Communications.\textsuperscript{292} Prosser proposed privatizing Emerging Communications by having all of its publicly owned shares acquired by Innovative Communications and then merging the two companies.\textsuperscript{293} A special committee of Emerging Communications directors approved the two-step transaction at the price proposed by Innovative Communications in reliance on a fairness opinion from Emerging Communications’ financial advisor stating that the price was fair to the minority stockholders.\textsuperscript{294} The financial advisor’s opinion, however, was based on stale financial projections.\textsuperscript{295} Updated financial projections, projections Prosser had not furnished to the financial advisor, reflected the intrinsic value of Emerging Communications and indicated substantial growth in its business.\textsuperscript{296} The stockholders, who had also not been provided with the current

\textsuperscript{289} \textit{In re Caremark Int’l Inc. Derivative Litig}, 698 A.2d 951, 970 (Del. Ch. 1996).
\textsuperscript{290} \textit{But see} Brown, \textit{supra} note 1, at 345 (arguing that the standard employed in \textit{Caremark} meant that directors would almost never be liable for a failure to monitor as a result of inadequate compliance procedures).
\textsuperscript{291} \textit{In re Emerging Commc’ns Inc. S’holders Litig.}, C.A. No. 16415, 2004 Del. Ch. LEXIS 70, at *143-47 (Del. Ch. 2004).
\textsuperscript{292} \textit{Id}. at *6.
\textsuperscript{293} \textit{Id}. at *2-3.
\textsuperscript{294} \textit{Id}. at *33-34.
\textsuperscript{295} \textit{Id}. at *25, 27.
\textsuperscript{296} \textit{Id}.
financial projections, voted to approve the merger.297

After the transaction closed, the minority stockholders sued Emerging Communications’ directors, claiming that the members of the special committee breached their fiduciary duties of loyalty and good faith by approving the transaction.298 As in Disney, the Chancery Court performed a director-by-director analysis to determine whether any of the directors had breached their fiduciary duties.299 One director, Salvatore Muoio, was a principal of an investment-advising firm, and had significant experience in telecommunications-sector financial matters.300 The Chancery Court determined that, because of Muoio’s experience, he knew, or should have known, the intrinsic value of Emerging Communications, and that the merger price was unfair.301 Thus the court determined that Muoio was not able, in good faith, to rely on the financial consultant’s fairness opinion in establishing his exercise of business judgment.302 The court further reasoned that because Muoio approved the transaction, he either did so to advance his own self-interest or had consciously and intentionally disregarded his responsibilities; in either case, amounting to a breach of the duty of loyalty or an act of bad faith.303 The court criticized Muoio for not advocating to the board to reject the price offered, or go on record as rejecting the price, as his expertise should have led him to conclude that the proposed merger price was not fair.304

The Reform calls for increased financial expertise on the audit committee.305 Presumably reflecting what has become a standard practice, private companies have also been including directors with financial expertise on their boards.306 Under Commission rules, being

297. Id. at *34-35, *132-34.
298. Id. at *35-36.
299. Id. at *140.
300. Id. at *143.
301. Id. at *143-44.
302. Id. at *144-45. The Chancery Court presumably determined that Muoio could not rely on the opinion under Section 141(e) of the DGCL. Id.
303. Id. at *145-47. The court did not distinguish the duty of loyalty from the duty of good faith. Id.
304. Id. at *144.
305. See supra Part III.C.
306. See Foley & Lardner Study, supra note 206 (finding that close to 70% of the responding private companies added or intended to add a financial expert on the audit committee following the Reform).
labeled an audit committee financial expert does not expose that director to liability as an expert under federal securities laws. However, as Emerging Communications reveals, a director with financial expertise might not be justified in relying on a financial advisor’s report or opinion under Section 141(e) of the DGCL to establish his business judgment if his own expertise should have caused him to question that report or opinion. This also pertains to a director’s ability to rely on information furnished by, or a statement made by, an officer where the director has reason to doubt that information or statement.

In Emerging Communications, the court did not focus on what Muoio actually knew, but looked to what he should have known based on his training and experience, in determining how Muoio’s conduct fell short. In this way, training and experience seem to raise the expected level of conduct for directors, regardless of personal competence. This might impose an obligation, at least on accounting and financial experts, to keep apprised of developments in the accounting industry at the risk of falling below the standard of conduct a court expects from directors with such experience and training. In this way, a director’s specialized knowledge and background, sought and encouraged under the Reform, may impose additional responsibilities on that director and expose him to potential liability in the fiduciary duty context.

**B. Director Independence Post-Reform**

**1. Duty of Loyalty**

The shift in fiduciary duties post-Reform is also apparent in the analysis of director independence. The best way to demonstrate this

308. See Lawrence E. Mitchell, The Sarbanes-Oxley Act and the Reinvention of Corporate Governance?, 48 VILL. L. REV. 1189, 1199 (2003) (predicting that the audit committee financial expert’s increased access to information will heighten his legal responsibilities despite assurances from the Commission).
309. See supra note 36 and accompanying text.
310. Johnson, supra note 6, at 33 (“A director with special accounting skills or training may not be warranted in relying in a situation where an untrained director might be warranted in relying. Likewise, one or more directors with information unknown to other directors may not be able to rely as broadly as other directors.”).
311. Id. at 51 (noting that a director with special skills, background or expertise may have greater responsibility whether or not he is designated as an expert).
shift, initially in the duty of loyalty context, is by way of example.

FSC, a sulfur company, and MOXY, an oil and gas exploration company, were sister corporations spun off from the same company.312 In 1998, the boards of both FMS and MOXY decided that the two siblings would benefit from being reunited, and so considered merging the two.313 Each corporation formed a special committee to negotiate the terms of the merger.314 After some negotiations, the two special committees arrived at an agreement as to the terms of the merger.315 Each committee then submitted the merger proposal to, and received approval from, its respective board.316 The stockholders of both companies subsequently approved the merger.317 After consummation of the merger, the stockholders of FSC sued the former FSC directors, alleging that they had breached their fiduciary duties by approving the merger with MOXY.318

According to the plaintiffs, the five former FSC directors not on the special committee were interested in the transaction with MOXY.319 Thus, the board’s approval of the merger did not cleanse the transaction under Section 144(a) of the DGCL, and the board was not entitled to the protection of the business judgment rule.320 The lower court found that the pleadings called into question whether a majority of the directors was interested.321 But the defendant directors’ motion to dismiss was granted because the complaint did not establish that those interests “impugned” the special committee’s deliberations or negotiations.322 On appeal, the Delaware Supreme Court reversed.323 According to the

313. Id. at 279-80.
314. Id. at 280.
315. Id.
316. Id.
317. Id. at 281.
318. Id. The court did not clearly specify which fiduciary duties were allegedly breached by the directors, but in its analysis it focused on whether the defendant directors had disabling conflicts and whether those interests were cleansed by approval of the special committee, thus implying that the key claim was a breach of the duty of loyalty.
319. Id.
320. Id. at 282.
321. Id.
322. Id.
323. Id. at 289.
court, the plaintiffs were entitled, at the pleading stage, to the inference that a majority of the directors was not independent or disinterested. The defendant directors had the burden of proving that the merger was approved by a committee of disinterested directors, acting independently, with real bargaining power to negotiate the terms of the merger. Because they did not meet this burden, their motion to dismiss was denied.

By placing the burden of proving independence on the directors, the Delaware Supreme Court has indicated that independence is not presumed, and must be affirmatively established. Plaintiffs then have the opportunity to discredit that evidence, not only by revealing ties between an interested party and special committee members, but also, *a la Krasner*, by showing how the mere presence of an interested party in the board approval process impugned that process.

The Delaware courts seem to have become more sensitive to the potential for bias associated with an interested party transaction, particularly in the current climate of skepticism towards directors. Consequently, in a cleansing board approval setting, directors would be wise to consider factors that might compromise independent approval up front, or risk having a court decide after the fact that the approval process did not remove the interested party taint, thereby giving the court the opportunity to review the substance of the transaction for fairness. It is in this way that an independence inquiry might unlock a duty of loyalty case for a plaintiff.

In the context of an interested party transaction, raising the bar on independence is consistent with the Reform’s policy of eliminating competing personal interests. It may also reflect the Delaware courts’ increased skepticism as to the cleansing power of the independent

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324. *Id.* at 284.
325. *Id.* at 284-85.
326. *Id.* at 286.
328. Orman v. Cullman, 794 A.2d 5, 21 (Del. Ch. 2002) (quoting Kahn v. Lynch Comm. Sys., Inc., 638 A.2d 1110, 1115 (Del. 1994)) (noting that a determination that entire fairness is the appropriate standard of review is of critical importance to a case and normally will preclude dismissal of a complaint on a motion to dismiss).
329. See *SENATE REPORT*, *supra* note 134, at Title III.A. (opining that many recent failures have been attributed to close ties between audit committee members and management); Campos, *supra* note 164, at 529; see also *supra* note 164 and accompanying text.
director approval process. As Vice Chancellor Strine has indicated, a stockholder vote based on full information creates a greater appearance of fairness than independent director approval because the stockholders have the chance to protect themselves, and are not forced to rely on the skills and integrity of the board. Perhaps stockholder solicitation will become a more attractive option in Delaware as increasing difficulty in establishing a valid cleansing board approval under Section 144(a) of the DGCL could lead to more proceedings beyond the motion to dismiss phase.

Still, Vice Chancellors Chandler and Strine have been careful to note that failing to satisfy the heightened independence inquiry does not determine whether a conflict of interest, for which an interested director may be liable, exists. But if that interest prevents a director from being impartial, it may be relevant to a court determining whether a director acted with the necessary state of mind for a breach of the duty of loyalty, such as bad faith.

2. Demand Futility and the SLC

Independence again comes into play where a stockholder has commenced a derivative suit and alleges that demand is futile, due to the fact that either the directors are not disinterested or independent, or that the challenged transaction was not the product of a valid exercise of business judgment. A director has traditionally not been viewed as independent in this context if her decision is based on extraneous

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330. Strine, supra note 33, at 1399 (“The parade of Enron executives and directors who went before the Congress to plead guilty to ignorance about key financial issues is arguably difficult to reconcile with the ideal of paternalistic and all-knowing directors acting as the faithful market intermediaries for the stockholders.”).
331. Id. at 1401. But cf. Eisenberg, supra note 4, at 456, with Eisenberg, supra note 4, at 456 (making the counterpoint that it is hard to be confident that stockholders who are sent proxy statements that include a proposal for their consideration will study and fully understand the relevant issues).
332. The NASD rules require that all related party transactions be approved by the listed company’s audit committee or comparable body. See NASDAQ Manual, supra note 152, § 4350(h). Thus, a stockholder ratification would not cleanse an interested party transaction.
333. Chandler et al., supra note 21, at 998.
334. See id.
considerations rather than the corporate merits of the matter before the board.\textsuperscript{336} Delaware courts have generally focused on whether a director is dominated or controlled by an interested party when determining if her decision was based on extraneous considerations.\textsuperscript{337}

The Delaware Chancery Court recently confirmed the notion that a director’s consideration of extraneous considerations shows a lack of independence in \textit{Beam ex rel Martha Stewart Living Omnimedia, Inc. v. Stewart}.\textsuperscript{338} In \textit{Beam}, a stockholder of Martha Stewart Living Omnimedia (MSLO) alleged that Martha Stewart breached her fiduciary duties to MSLO by selling shares of ImClone and making public statements detrimental to MSLO regarding the sale.\textsuperscript{339} The stockholder did not make demand on the board of MSLO, arguing that demand would have been futile.\textsuperscript{340} The Chancery Court easily determined that Stewart was not independent for purposes of demand futility, as she was the subject of the litigation giving rise to the demand requirement.\textsuperscript{341} The court also determined that MSLO’s chief operating officer, also on the board, was not independent because Stewart was MSLO’s senior executive, and thus had the ability to affect her employment and compensation.\textsuperscript{342} The court then turned to the outside directors; the fact that Stewart controlled 94\% of MSLO, and had the power to elect and remove directors, was not dispositive of those directors’ independence.\textsuperscript{343} Instead, the court considered whether remaining on the board of MSLO was material to each outside director, such that each director was unable to consider demand without factoring in this extraneous consideration.\textsuperscript{344} The Chancery Court ruled that the plaintiff’s complaint did not establish a lack of director independence, as it failed to present evidence that any of the outside directors had

\begin{itemize}
  \item \textsuperscript{336} \textit{Id.} at 815.
  \item \textsuperscript{337} \textit{Id.}
  \item \textsuperscript{338} \textit{Beam ex rel Martha Stewart Living Omnimedia, Inc. v. Stewart}, 833 A.2d 961, 977 (Del. Ch. 2003).
  \item \textsuperscript{339} \textit{Id.} at 977.
  \item \textsuperscript{340} \textit{Id.} at 976. The Chancery Court applied the \textit{Rales} test for demand futility because the challenged action was the sale by Stewart of her shares in ImClone and her associated public statements—it was not based on a decision by the board of MSLO. \textit{Id.} at 977 (citing \textit{Rales v. Blasband}, 634 A.2d 927 (Del. 1993)).
  \item \textsuperscript{341} \textit{Id.} at 977.
  \item \textsuperscript{342} \textit{Id.} at 977-78.
  \item \textsuperscript{343} \textit{Id.} at 978.
  \item \textsuperscript{344} \textit{Id.}
\end{itemize}
previously followed Stewart’s will or recommendations without independent investigation. The court acknowledged that some professional or personal friendships may raise reasonable doubt as to director independence, but the pleadings in this case did not create that doubt as to any of the outside directors.

While not performing a detailed analysis of the MSLO board’s independence in *Beam*, presumably due to a lack of facts in the pleadings to enable this analysis, the court did not focus solely on notions of domination and control in its analysis, the traditional focus of the independence inquiry in the demand futility context. Nevertheless, this case seems to illustrate the consequence of deficient pleadings, rather than serving as a guide as to independence. Admittedly, the Chancery Court gave substantial weight to its seemingly *sua sponte* determination that the reputations of two directors prevented them from making a decision that gave undue consideration to their relationships with Stewart. But again, that determination may have resulted from deficient pleadings, leaving the Chancery Court to make logical leaps as to the various factors affecting independence. At a minimum, *Beam* does suggest that in determining demand futility, the Delaware courts may be shifting the independence inquiry from a question of control to a more contextual inquiry, as seen in the duty of loyalty context.

The Delaware courts have given clearer guidance on the nature of independence in the derivative suit context, where an action has been commenced, and a board has formed a SLC to decide whether to dismiss

345. *Id.* at 978-79.
346. *Id.* at 979.
347. *Id.* at 979-81. The Chancery Court found that Stewart’s long-standing friendship with two directors did not compromise their independence, as the court was persuaded that those directors would not harm their reputations by failing to fulfill their fiduciary duties. *Id.* at 980. However, the court chastised the plaintiff for not having used the “tools at hand” to obtain more facts on those friendships, and instead relying on general, conclusory statements. *Id.* at 981-82. *But see* California Pub. Employees’ Ret. Sys. v. Coulter, 2002 WL 31888343, at *9 (Del. Ch. 2002) (holding that while personal friendships, without more, outside business relationships, without more, and approving of or acquiescing in the challenged transaction, without more, are each insufficient to raise a reasonable doubt as to a director’s ability to exercise independent business judgment, they can, taken together, create a reasonable doubt as to independence).
348. *See supra* Part II.E.
Another virtual trip to the Delaware courts will help explain. In 2001, four Oracle directors sold shares in Oracle allegedly on the basis of material non-public information. The non-public information related to “bugs” with an important new Oracle program, as well as declining sales of other products. This information revealed that the earnings projections Oracle had provided to the market were no longer accurate. Plaintiffs, stockholders in Oracle, sued the four defendant directors, alleging they breached their duty of loyalty in misappropriating insider information, and using it as the basis for making stock trades. Plaintiffs also sued the other Oracle directors, alleging that they had breached their duty of oversight by not correcting the misleading information in the market about Oracle’s performance in such a way so as to amount to bad faith.

The Oracle board formed a SLC with two tenured Stanford professors to investigate whether dismissing the suit was in Oracle’s best interest. The SLC performed an extensive inquiry into the plaintiffs’ complaint, with significant involvement from its independent external counsel. Based on these investigations, the SLC determined that proceeding with the lawsuit was not in Oracle’s best interest, and moved to dismiss.

Relying on Zapata v. Maldonado, the Chancery Court placed the burden on the SLC members to prove that: they were independent, acted in good faith, and had a reasonable basis for their recommendation to dismiss the suit. The two SLC members argued that they were independent because they did not receive compensation from Oracle other than as directors, and were in fact willing to return their fees for serving as SLC members if that was necessary to preserve their independence. Further, the SLC members were not on Oracle’s board

349. See id.
351. Id. at 922.
352. Id. at 921-22.
353. Id. at 923.
354. Id.
355. Id.
356. Id. at 925.
357. Id.
358. Id. at 928 (citing Zapata Corp. v. Maldonado, 430 A.2d 779, 788-89 (Del. 1981)).
359. Id. at 929.
at the time of the alleged wrongdoing, and in their view, did not have any material ties with the defendant directors. But a number of ties between the SLC members and the defendant directors emerged during discovery. Specifically, it was discovered that one of the defendant directors had taught one of the SLC members while at Stanford, and was also on a Stanford policy committee with that same SLC member. Another director personally made and directed, through a charitable institution, substantial donations to two organizations at Stanford with which one of the SLC members was affiliated. A third defendant, the CEO of Oracle, was the sole director of a charitable institution that had made substantial donations to Stanford. The CEO had also caused Oracle to make donations to Stanford, and was considering establishing a $170 million scholarship program through Stanford at the time of the challenged stock trades. The SLC members argued that these ties did not impair their independence, as they were both tenured professors who were not susceptible to professional punishment for making decisions adverse to the defendant directors. Additionally, their positions did not depend on their fund-raising efforts.

The Chancery Court recognized that existing jurisprudence concerning the determination of independence focused on questions of domination and control. But, in the court’s view, “an emphasis on ‘domination and control’ would serve only to fetishize much-parroted language, at the cost of denuding the independence inquiry of its intellectual integrity.” Recognizing that humans are not solely motivated by economic considerations, the court viewed independence contextually, looking to whether either SLC member was, for any substantial reason, incapable of making a decision with only the best interests of the corporation in mind. The court took notice of the new

360. Id.
361. In re Oracle Derivative Litig., 824 A.2d at 929.
362. Id. at 931.
363. Id. at 931-32.
364. Id. at 932.
365. Id. at 933.
366. Id. at 935-36.
367. Id. at 936.
368. Id. at 937.
369. Id.
370. Id. at 937-39.
definition of independence created under the Reform;\textsuperscript{371} while disfavoring the use of blanket labels in defining independence, the court supported the proposition recognized in the Reform that independence depends on the particular circumstances.\textsuperscript{372}

Using this contextual approach, the Chancery Court found that the SLC had not proven the absence of a material fact regarding its members’ independence, as its report did not even mention the Stanford ties between the SLC members and the defendant directors.\textsuperscript{373} For the court, the significant question was whether a person in a SLC member’s position would find it difficult to assess a defendant director’s conduct without pondering his own association with that director and their mutual affiliations.\textsuperscript{374} A SLC member would not be considered independent of the director if that SLC member was unable to decide without that association “be[ing] on the[ir] mind.”\textsuperscript{375}

One of the reasons for the court’s careful scrutiny of independence in Oracle is the extraordinary importance, and difficulty, facing SLC members who must decide whether to accuse a fellow director of misconduct with less than full board support.\textsuperscript{376} While this might explain why the Chancery Court found director independence in Beam but not in Oracle, it seems to be as difficult to decide whether to sue a director in the first instance as to decide to proceed with a suit against her. Perhaps a better explanation is that the plaintiffs in Beam had the burden of proving the lack of board independence, whereas the directors in Oracle had the burden of establishing their independence. Viewed this way, the allocation of the burden of proof may have a strong bearing on the nature and outcome of the independence inquiry.\textsuperscript{377} Moreover, if,

\textsuperscript{371} Id. at 940 n.62.
\textsuperscript{372} Id. Vice Chancellors Chandler and Strine have noted that there is a great deal of harmony between the sentiments of the Reform and Delaware case law as to the independent director concept, particularly to the extent that the Reform recognizes the independence-compromising effects of consultant contracts, familial ties and other factors. See Chandler et al., supra note 21, at 960-61. Hence in the Vice Chancellors’ view, the Reform may have the virtue of simplifying some aspects of corporate litigation, as it gives clear guidance as to what does not amount to independence. Id. at 961.
\textsuperscript{373} In re Oracle Derivative Litig., 824 A.2d at 942-43.
\textsuperscript{374} See id. at 943.
\textsuperscript{375} See id.
\textsuperscript{376} See id. at 921, 940.
\textsuperscript{377} See Davis, supra note 168, at 1315 (arguing that the Chancery Court’s
as Vice Chancellor Strine has suggested, the heightened judicial scrutiny on independence seen in Oracle reflects heightened pressure from plaintiffs to presume that any tie with an interested director precludes a finding of independence, at least at the pleading stage, perhaps plaintiffs in other contexts will demand the same level of searching inquiry and skepticism, arguing that extraneous considerations should never be a factor in board decisions. 378

The contextual and sensitive nature of the independence inquiries seen in Oracle and Krasner give the Delaware courts a significant amount of discretion in determining the point at which a director’s relationships, whether personal, familial, charitable or other, compromise his independence. This might enable courts to find independence only where “the court feels that it can trust the directors.” 379 Perhaps courts will be more willing to trust directors in less tumultuous times, when not faced with widespread skepticism as to directors’ ability to effectively and neutrally monitor management.

3. Independence—Where Delaware Law and the Reform Meet

The Delaware trend towards scrutinizing a broad range of factors bearing on independence is consistent with the Reform’s call for greater director independence, particularly from management. 380 This emphasis on independence, in both the context of board and committee

outcome-determinative characterization of independence in Beam suggests that the court accepts some variance as a practical consequence of how the burden of proof is allocated).

378. See Strine, supra note 33, at 1383.
379. See id. at 1385 (referring to statements made by former Chief Justice Veasey).
380. Chandler et al., supra note 21, at 961 n.15 (“Delaware law recognizes that charitable relationships between a director and another constituent of the corporation (or the corporation itself) should be considered as factors in determining whether the director’s independence has been compromised.”); Veasey, Access to Justice, supra note 254, at 14 (noting that the independence concepts under the Reform are not inconsistent with Delaware case law, though are somewhat more explicit). According to Vice Chancellors Chandler and Strine, “For the most part, it should be the case that satisfaction of the new Exchange Rule independence standards will enable a director, at least as a prima facie matter, to be labeled as ‘independent.’” Chandler et al., supra note 21, at 988. But see Brown, supra note 1, at 372 (indicating that SOX does not alter state law cases characterizing a director as independent, even though he has long-standing business and personal ties to the chief executive officer).
composition under the Reform, and in the context of the board’s exercise of its duties under state fiduciary duty law, is not surprising following the discovery of widespread accounting abuses that unquestioning, passive boards largely missed because of their close ties to management.\textsuperscript{381} It also likely addresses the skepticism of judges as to whether there is such a thing as an “independent director,” given the heavy role management plays in selecting directors, the fact that independent directors are usually managers of other corporations, and the social affinities that exist between directors and managers.\textsuperscript{382}

Despite the trend in Delaware towards harmonizing the independence determination in the fiduciary duty analysis with the Reform’s rules on independence, members of the Delaware judiciary have indicated that they do not agree with, and do not intend to follow, the Reform’s classification as non-independent directors who own, or are affiliated with a person who owns, a substantial but non-controlling block of stock.\textsuperscript{383} According to Vice Chancellors Chandler and Strine, this “is contrary to much good thinking in academia and in Delaware decision law, both of which have taken the view that independent directors who have a substantial stake as common stockholders in the company’s success are better motivated to diligently and faithfully oversee management.”\textsuperscript{384} This observation is especially relevant in the current environment, where stockholders are increasingly demanding to have their nominees placed on the board.

Critics of the heightened independence mandate argue that independence does not always lead to improved firm performance.\textsuperscript{385} However, independence likely eliminates or reduces competing personal

\begin{itemize}
\item \textsuperscript{381} See Campos, supra note 164, at 540-41 (agreeing with Vice Chancellor Strine’s message in \textit{Oracle} that in determining independence, it is important to look not only to specific requirements that exist (for example, through the NYSE and NASDAQ listing standards) but also to carefully consider any sort of relationship that could be deemed to impair independence); see also supra note 1 and accompanying text.
\item \textsuperscript{382} See Strine, supra note 33, at 1374-75.
\item \textsuperscript{383} Chandler et al., supra note 21, at 989-96 (challenging the preclusion of a finding of independence under SOX where a director owns or is affiliated with a stockholder).
\item \textsuperscript{384} Id. at 992; see also Usha Rodrigues, \textit{Let the Money Do the Governing: The Case for Reuniting Ownership and Control}, 9 \textit{STAN. J.L. BUS. & FIN.} 254, 256 (2004) (promoting inclusion of one stockholder nominee independent of management on the board).
\item \textsuperscript{385} Bhagat et al., supra note 167; see Davis, supra note 168, at 1340.
\end{itemize}
interests that might “be on the mind” of a director when making a business decision. This, in turn, likely gives stockholders a greater sense of impartiality, important in an environment when the corporate parade of evils has been seemingly commanded by conflicted, passive directors.

C. Duty of Candor/Disclosure Post-Reform

In Emerging Communications, presented above, the Delaware Chancery Court found that the directors of Emerging Communications had breached their duty of disclosure to the stockholders by failing to provide current financial projections of Emerging Communications that reflected its true value.\textsuperscript{386} Thus, the stockholders’ approval was ineffective under Section 144(a) of the DGCL.\textsuperscript{387} While the Chancery Court acknowledged that projections were not required to be provided to the stockholders as a matter of course, the fact that they had been provided to Prosser, the sole stockholder of Innovative Communications, meant that they had to be provided to all stockholders, and the failure to do so was a material omission.\textsuperscript{388} The Chancery Court also found that the proxy material was materially misleading in that it suggested that the members of the special committee were independent when in fact they were not, and in stating that the special committee comprised a majority of the board, although it did not.\textsuperscript{389} For that reason, along with others cited, the court found that the merger price was not the product of fair dealing, and the defendant directors had not proven the fairness of the transaction.\textsuperscript{390}

As section B presented, Delaware’s standard of independence is changing as stockholders expect and demand directors with more pluck who are independent from, and who are willing to question, management. As Emerging Communications shows, this emphasis emerges again in the stockholder solicitation context, where directors must, under their duty of candor, disclose to stockholders any relationship that might bear on the board’s independent approval of an interested party transaction. This again reveals the Delaware courts’

\textsuperscript{386} In re Emerging Commc’ns Inc. S’holders Litig., No. 16415, 2004 Del. Ch. LEXIS 70, at *131-32 (Del. Ch. 2004).
\textsuperscript{387} See discussion supra Parts II.B, II.C.
\textsuperscript{388} In re Emerging Commc’ns, 2004 Del. Ch. LEXIS 70, at *134.
\textsuperscript{389} Id. at *135.
\textsuperscript{390} Id. at *116-37.
emphasis on the need to assure stockholders of the integrity and fairness
of board processes through independence.

While Delaware’s duty of candor does not derive from compliance
with specific disclosure obligations under federal securities laws, Dela
aware courts have given deference to federal disclosure standards in
shaping the state fiduciary duty of candor. Consequently, a violation
of any of the new SOX disclosure obligations placed on public
companies may give rise to a state law fiduciary duty of candor claim, or
may eliminate the cleansing effect of stockholder approval of an
interested party transaction and also prove the absence of fairness.

Perhaps more significant, as companies implement enhanced
information and reporting systems, they generate mountains of
additional information about internal processes, plans, procedures and
the like. Much of this is reported to the audit committee. This greatly
expands the definition of information that is “reasonably available” and
that may need to be provided to stockholders when soliciting their
approval. Further, public companies must periodically report the
information generated by these enhanced systems to their stockholders.
This disclosure may significantly increase the types of fiduciary duty
claims that stockholders are able prove.

D. Are We There Yet?

While directors may take some comfort from the fact that their
fiduciary duties have not been turned inside-out and upside-down amidst
the ambitious corporate governance reform, the changes that have
occurred in the short time since the Reform took effect are notable.
Most importantly, Delaware courts seem poised to employ good faith
through the duty of loyalty to enforce directors’ discharge of their
oversight responsibilities. As Stone demonstrates, directors who
intentionally or consciously disregard those responsibilities may be held
liable as a result of breaching their duty of loyalty. As Disney instructs,
even a director who jumps over the minimum standard of conduct hurdle
can still face protracted litigation and court reprimand for sub-par
conduct. This is particularly significant, as directors have an increasing

391. See discussion supra Part II.C.
392. Janssen, supra note 25, at 1593 (suggesting that the failure of care, loyalty and
waste claims has led to enforcement of the duty of good faith).
number of oversight responsibilities to discharge.\textsuperscript{393}

Director independence is a corollary to the duty of oversight, aimed at enhancing directors’ ability to perform their responsibilities without associations that can compromise their impartiality or effectiveness. Toward that end, the Delaware courts have been scrutinizing a broad range of factors that might impair independence, supported by the Reform’s expansive list of factors precluding a finding of independence. The consequence of a broader independence inquiry, as Oracle and Krasner show, is that it allows stockholders to throw more challenges to director independence at the court, increasing the chances that one of those challenges will stick. Those cases also seem to cast a wider net on what directors must consider and investigate where they have the burden of establishing their independence. Directors can take some comfort from the message of members of the Delaware judiciary that the lack of independence does not equate to being interested for purposes of the duty of loyalty. However, the two concepts converge where a majority of independent directors approves an interested party transaction, yet the directors are not able to establish their independence at trial, as in Krasner. The result is the application of the fairness standard of review; a standard allowing a court to review the substance of a transaction for fairness, often resulting in a different outcome than where a court defers to the directors’ exercise of business judgment.\textsuperscript{394} Independence might also overlap with good faith to the extent that a non-independent director’s approval of an interested party transaction is used to prove that the director acted with bad faith or without fully investigating whether she was in fact independent, in conscious disregard of her duty to do so.

That is not to say that the Delaware courts “have lurched into a new and menacing direction that should cause panic in the boardroom.”\textsuperscript{395}

\textsuperscript{393} See E. Norman Veasey, A Perspective on Liability Risks to Directors in Light of Current Events, 19 INSIGHTS: CORP. & SEC. L. ADVISOR 9, 11 (2005) [hereinafter, Veasey, Perspective] (“The evolution of director expectations occurs not only because courts must decide only the cases before them, but also because business norms and mores change as well over time.”).

\textsuperscript{394} See supra note 328 and accompanying text.

\textsuperscript{395} According to the former Chief Justice of the Delaware Supreme Court, E. Norman Veasey, Caremark made clear that the expectation is that the board will implement modern governance norms, including effective law compliance programs. Veasey, Perspective, supra note 393, at 13.
But current Delaware case law suggests that the standards directors are judged by are evolving, as perhaps they should, to meet changing demands and the evolving corporate governance mandates reflected in the Reform.

So how does a director satisfy her evolving fiduciary duty? That is the topic of Part V.

V. HOW DOES A DIRECTOR DISCHARGE HER EVER-ELUSIVE FIDUCIARY DUTIES?

Being a director of a corporation is not an easy task—nor one to be taken lightly. That is particularly true in an environment where the corporate governance scale has been tipping towards increasing directors’ oversight responsibilities and making them accountable to stockholders. The corporate governance scale may have needed an adjustment after the bursting of the dot-com and telecom bubbles because directors in many instances had failed to serve as an effective check on management’s practices of engaging in short-term market manipulations to increase the price of stock, and to introduce a healthy dose of skepticism into the boardroom.

The biggest and most immediate adjustment to the corporate governance scale originated with the Reform. By mandating specific oversight duties audit committee directors must perform and qualifications directors must have, the Reform does not leave much room to question what, at a minimum, is expected from directors along these lines. That might explain why directors of companies not subject to the Reform are also implementing Reform-style governance practices, for they too understand that the bar has been raised and that more is expected of them.

While the Reform increased the expected level of director conduct, Delaware courts have been adjusting the standard of review for that conduct. Prior to the enactment of the Reform, Delaware courts did

396. See discussion supra Parts III-IV.
397. See Coffee, supra note 128, at 298 (arguing that there was an incentive to inflate the price of stock by premature revenue recognition, enabling management to bail out in the short-term by exercising options and immediately selling their stock).
398. See discussion supra Part IV.
399. A standard of review is a test that a court applies when it reviews an actor’s conduct to determine whether or not to impose liability or grant injunctive relief.
not generally provide stockholders with a remedy for directors’ oversight lapses, whether or not involving a business decision, absent a conflict of interest.  But by shifting their focus to good faith, and performing the fiduciary duty analysis using that standard, the Delaware courts have indicated a willingness and way to enforce directors’ oversight responsibilities through personal liability. Just as the Delaware courts use the business judgment rule to implement a policy of judicial deference to business decisions, so too has good faith become a tool by which those courts have started to implement a policy of giving more careful scrutiny and attention to ordinary business decisions and oversight responsibilities. Thus, as the standard of conduct requires directors to perform an increased number of oversight duties, the standard of review has shifted closer, exposing a director to an increased risk of personal liability for failing to perform his duties in good faith. That is not to say that there has been a wild swing in fiduciary duty law following the Reform. The fact that the directors of both Disney and AmSouth were not adjudged liable seems to demonstrate the continuing trend in Delaware towards director absolution. However, cases such as Disney and Stone, where the Delaware courts gave substantial attention to the performance by the directors of their routine duties and measured the board failures by a standard of liability that is coming more into focus, suggest a new direction for the Delaware courts.

Moreover, personal liability for oversight failures is not the only land mine directors may encounter; as in Disney, directors may face years of litigation even where their conduct does not amount to bad faith. Further still, also seen in Disney, directors face the risk of court rebuke for failing to employ best practices. For directors, who are often esteemed members of society, this type of public rebuke can seriously harm their reputations and impair their business prospects.

Eisenberg, supra note 4, at 437. A standard of conduct provides how an actor should conduct a given activity or play a given role. Id. Often the standard of review and standard of conduct diverge, for example, in the case of the duty of care, where Delaware courts expect directors to employ best practices, yet give deference to their business decisions under the business judgment rule. Id. at 443.

400. See discussion supra Part II.
401. Allen et al., supra note 3, at 1294-95.
402. See Lynn A. Stout, On the Proper Motives of Corporate Directors (Or, Why You Don’t Want to Invite Homo Economicus to Join Your Board), 28 DEL. J. CORP. L. 1, 4 (2003) (noting that directors are generally successful professionals).
Delaware courts have also been able to more closely align standards of review with changing standards of conduct by expanding the scope of the independence review. A decision made by a SLC comprised of independent, disinterested directors prevents a court from hearing the merits of a case. Independent board approval also prevents a court from reviewing an interested party transaction for fairness. In both cases, where the independence of directors involved in the approval process is questioned, a court has broad discretion, given the contextual fact-specific nature of the independence inquiry, to determine whether that lack of independence impugned the approval process. Where a court finds that the approval process has been impugned, the court may review the transaction and determine whether it satisfies the applicable standard of review. Thus, by giving more teeth to the independence inquiry, the courts have increased the likelihood that they will review director conduct and, in the case of interested party transactions, that they will review the fairness of those transactions.

Though the standard of review appears to be approaching the heightened standard of post-Reform conduct, the two still appear to be on separate planes. As Chancellor Chandler has noted,

Delaware law does not—indeed, the common law cannot—hold fiduciaries liable for a failure to comply with the aspirational ideal of best practices, any more than a common-law court deciding a medical malpractice dispute can impose a standard of liability based on ideal—rather than competent or standard-medical treatment practices, lest the average medical practitioner be found inevitably derelict.

Though the Delaware courts have not expounded on what amounts to best practices, they have been quick to note conduct that does not measure up. For instance in Disney IV, the Delaware Chancery Court pointed out numerous instances where the directors’ conduct fell short of

403. Veasey, Perspective, supra note 393, at 10 (“[T]here are some court cases where directors may be held personally accountable. But they are not, in my opinion, a menacing trend and are explainable as law and business mores and expectations of directors’ processes continue to evolve.”); but see id. at 11 (“The fact that the standards of review applied by Delaware courts to the standards of director conduct has resulted in some findings of wrongdoing is primarily a function of intensified judicial focus on process and improved pleadings by plaintiffs’ lawyers.”).

best practices.\textsuperscript{405} Similarly, in \textit{Disney V}, the Delaware Supreme Court repeatedly rebuked the directors for failing to comply with best practices. This suggests that compliance with best practices may be a director’s insurance policy against the risks that he will be held liable for having breached his fiduciary duties, or that he will be rebuked for failing to employ best practices. It may also prevent a director from facing time-consuming litigation, as his conduct will at least be on the same plane as stockholders’ expectations.

Compliance with good corporate practices, somewhere above bad faith but falling short of best practices, may or may not preclude a director from being reprimanded by a court or involved in protracted litigation. It is not clear from \textit{Disney} how short the Disney directors’ conduct fell from aspirational practices. Still, their conduct was sufficient for them to avoid personal liability. As former Chief Justice Veasey has previously noted, “Good corporate practices, when genuinely used, in my view, would perforce and simultaneously lead directors to act in good faith.”\textsuperscript{406} In this way, compliance with good corporate practices seems to serve as an insurance policy against the risk of liability for a breach of the duty of loyalty for actions taken in bad faith.

Because the Delaware courts have not been clear as to what amounts to good or best practices, it is difficult to know both where the line between the two is drawn and the differences between them. In fact, there may still be more layers between good practices and bad faith, such as competent practices or adequate practices. But even without fully understanding all of the levels of conduct that might fall between the two, it seems clear that the Delaware courts intend to encourage best practices, and are willing to use available tools, short of imposing liability, to bring about the employment of those practices.\textsuperscript{407}

\textsuperscript{405} See, e.g., id. at *191 (“By virtue of his Machiavellian (and imperial) nature as CEO . . . Eisner to a large extent is responsible for the failings in process that infected and handicapped the board’s decision making abilities.”).

\textsuperscript{406} Veasey, \textit{Counseling Directors}, supra note 141, at 1456; see also Hamilton et al., \textit{supra} note 2, at 25 (stating that ideals of good corporate governance practices that go beyond the minimal legal requirements are desirable, tend to benefit stockholders, and can usually help directors avoid liability).

\textsuperscript{407} This is consistent with Professor Eisenberg’s view that standards of conduct (such as best practices) are “safe” rules and standards of review (such as good faith) are “risky” rules. See Eisenberg, \textit{supra} note 4, at 464. According to Professor Eisenberg, a
So what amounts to best corporate practices? Not surprisingly, it depends. Specifically, what amounts to best practices will invariably depend on the circumstances and will vary by company, depending on factors such as industry, number of stockholders and size. As Vice Chancellors Chandler and Strine have noted, “there must be room [in fiduciary law] for creativity and innovation and that the law must accommodate the diversity that exists in corporate America.” Perhaps the fact that best practices are as amorphous as good faith will allow the Delaware courts to draw an imaginary line between them, allowing any director who conforms his conduct to a standard of conduct knows that he is safe from liability, whereas a director who relies only on the standard of review that is less demanding is at risk that the standard of review will be deemed inapplicable and liability will be imposed under the standard of conduct. Id. Some studies indicate that there is a positive relationship between good corporate governance and firm value. BNA Inc., 3 Corporate Accountability Report 57 (2005) (referring to empirical evidence that shows that there is a link between returns and governance). If there is indeed a positive correlation, implementing good corporate practices can be rationalized not only as a liability avoidance measure, but also as a value creation measure for stockholders.

408. Allen et al., supra note 3, at 1294. Allen notes reasons why courts have had trouble defining precise guidelines:

[T]he almost infinite potential variation in the fact patterns calling for director decisions, the disparate time frames within which different boards may be required to act, and the divergent skills and information needed to make particular business decisions, usually make it impossible for courts to articulate ex ante precise guidelines for appropriate fiduciary action in future cases. Id.

409. For example, best practices for a high-tech company with a complicated business plan would be different than for a company that manufactures widgets.


412. Chandler et al., supra note 21, at 978. The downside to variable good corporate governance practices is that it is difficult to know what they are.
wave of corporate governance reform to erase the line and the Delaware courts to redraw it. The Reform has indeed shifted the line, with many former best practices now constituting a statutory minimum that must be implemented to comply with fiduciary duties. Still, the Delaware courts’ adherence to the doctrine of *stare decisis*, and the slow evolution of decisional law, should give directors the opportunity—at least directors who are paying attention to their duties—to understand and adjust their conduct to meet evolving expectations.

VI. CONCLUSION

While competent, good, or best corporate practices vary from circumstance to circumstance, from company to company, and from time to time, the one common denominator is the need for directors to act in the best interest of stockholders. That seems to be the common trend found under the new duties and legal mandates under the Reform and state fiduciary duty law. Federal securities laws, SRO rules, organizational sentencing guidelines and state corporate law are all geared towards encouraging a corporate culture of wanting to do the right thing—though they differ on how to bring that about.\(^{413}\) The approach taken by the Reform—of enumerating specific responsibilities currently viewed as desirable by stockholders—seems to be bringing about conduct that gives the appearance of directors acting with the best interests of the stockholders in mind. However, that approach may not be sustainable in the long term, as stockholders’ expectations continue to shift to reflect the continually evolving nature of business. Delaware’s duty of good faith may be more appropriately suited for the task, as it affords courts, in an environment where stockholders’ expectations are continually evolving, the opportunity to look to the entire process employed by directors as a proxy for the directors’ good faith state of mind.\(^{414}\) Yet it remains to be seen how, and to what extent, Delaware and other state courts can and will use good faith through the duty of

\(^{413}\) See Johnson, *supra* note 6, at 39 (arguing that commentary from Delaware judges as well as remarks made by Chancellor Chandler in *Disney IV* “suggest that the key issue with respect to analyzing good faith is whether the director’s motivation and purpose was to advance the corporation’s interest”).

\(^{414}\) See Johnson et al., *supra* note 6, at 1194 (suggesting that the broad, ill-defined fiduciary duties in Delaware accord wide latitude to directors, which is highly functional given the strong process dimension to fiduciary analysis).
loyalty to bring about the “do the right thing” mindset.

But even with a standards-based approach, the method of encouraging best practices continues to focus on the disciplining stick and not the rewarding carrot. Perhaps a better approach is to make directors want to do the right thing. Directors might be encouraged to uphold high ethical business standards, not out of fear of facing possible stockholder derivative suits or court reprimand, but because they are rewarded for acting honestly and ethically, possibly through a financial bonus or positive corporate disclosure. This will be more effective if all corporations implement a similar incentive system, as stockholders will then be able to compare directors’ performance from corporation to corporation. Ultimately, while the threat of liability might be sufficient to prevent a director from engaging in certain practices, it may make more sense to encourage aspirational conduct by inspiring directors to engage in honest and ethical conduct.