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The Business Judgment Rule, Disclosure, and Executive Compensation

D.A. Jeremy Telman*

Despite its ubiquity in corporate law, the business judgment rule remains a doctrinal puzzle. Both courts and scholars offer different understandings of the Rule's role in litigation brought against corporate directors and different justifications for its deployment to insulate such directors from liability for breaches of fiduciary duties. This Article rejects all existing justifications for the Rule and argues that the Rule is no longer needed to protect directors from liability, either because the justifications offered never made any sense or because directors are now protected by other, statutory means. Rather, the Rule is needed today not to protect directors, but the corporations they serve from the irreparable harm corporations would suffer if forced to disclose prospective business plans in order to defend decisions taken by their boards. This Article follows some recent scholarship in arguing that the Rule is best understood as an abstention doctrine and argues that courts should invoke the Rule and abstain from the review of the business judgment of corporate directors when the litigation that gives rise to such review would compel the corporation to disclose information relating to its prospective business plans. The Article then illustrates why the Rule should not apply in cases involving challenges to board decisions relating to executive compensation through a detailed discussion of the ongoing litigation relating to the hiring and dismissal of the Walt Disney Company's former President, Michael Ovitz.

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I. INTRODUCTION

This Article contends that none of the conventional justifications for the business judgment rule (Rule) are entirely satisfactory, because the Rule is ordinarily defended as necessary to protect corporations' directors from liability, and directors are already protected by other means. Instead, this Article seeks to rethink the Rule as a means of protecting corporations from irreparable harms caused by litigation. This Article thus proposes that the Rule be aggressively conceived as a doctrine of abstention, pursuant to which courts refrain from substantive review of a board's decisions as long as the decision-making process was proper. However, this Article would limit application of the Rule to cases where disclosure of the decision-making process involved in the challenged business decision would require disclosure of prospective business plans. In order to illustrate one area where its proposal would make a difference in the deployment of the Rule, the Article focuses on one case involving allegations that a board breached its duty of care in connection with the approval of an executive compensation package. Because decisions relating to executive compensation generally do not involve prospective business plans, the Rule should not apply to preclude substantive review of board decisions relating to such compensation.

Part II of this Article points out the general weaknesses in the leading justifications of the Rule. In Part III.A, the Article proposes a different justification for the Rule: the need to protect corporations against disclosures of prospective business strategies underlying corporate decision making. However, the Article contends that the Rule should not protect corporations from disclosures in connection

with challenges to executive compensation. Finally, Part III.B looks at the suit brought by shareholders of the Walt Disney Company (Disney), alleging breaches of fiduciary duties in connection with the Disney board's decision to hire Michael Ovitz as the company's president and then to pay him $140 million in severance upon his termination after only fourteen months in office.[1]

II. WEAKNESSES IN THE DOCTRINAL EDIFICE

Pursuant to the Rule, courts generally defer to decisions taken by corporate directors, whether they relate to mergers and acquisitions,[2] paying out of dividends,[3] charitable donations,[4] or executive compensation,[5] as long as: (1) a business decision was made, (2) in good faith, (3) after the director reasonably informed herself, and

1. *See In re* Walt Disney Co. Derivative Litig., 907 A.2d 693, 697 (Del. Ch. 2005), *aff'd*, 906 A.2d 27 (Del. 2006) ("The stockholder plaintiffs have alleged that the director defendants breached their fiduciary duties in connection with the 1995 hiring and 1996 termination of Michael Ovitz as President of The Walt Disney Company."). This Article was conceived and written before the Delaware Supreme Court decision of June 8, 2006, affirming the judgment of the chancery court. *In re Disney*, 906 A.2d 27. This Article has not been revised in light of the supreme court's decision, because the supreme court affirmed not only the conclusion but also the reasoning of the chancery court.

2. *See* Unocal Corp. v. Mesa Petrol. Co., 493 A.2d 946, 954 (Del. 1985) ("[T]he [Rule], including the standards by which director conduct is judged, is applicable in the context of a takeover."); Smith v. Van Gorkom, 488 A.2d 858, 881 (Del. 1985) ("While suit might result from the rejection of a merger or tender offer, Delaware law makes clear that a board acting within the ambit of the [Rule] faces no ultimate liability.").

3. *See* Sinclair Oil Corp. v. Levien, 280 A.2d 717, 722 (Del. 1971) (holding that, in the absence of self-dealing, the business-judgment standard applies to a parent corporation's decision to have its subsidiary declare dividends); Dodge v. Ford Motor Co., 170 N.W. 668, 682 (Mich. 1919) ("'It is a well-recognized principle of law that the directors of a corporation, and they alone, have the power to declare a dividend of the earnings of the corporation, and to determine its amount.'" (quoting Hunter v. Roberts, Throp & Co., 47 N.W. 131, 134 (Mich. 1890))); Kamin v. Am. Express Co., 383 N.Y.S.2d 807, 810 (N.Y. Sup. Ct.), *aff'd*, 387 N.Y.S.2d 993 (N.Y. App. Div. 1976) ("[T]he question of whether or not a dividend is to be declared or a distribution of some kind should be made is exclusively a matter of business judgment for the Board of Directors."); Gottfried v. Gottfried, 73 N.Y.S.2d 692, 695 (N.Y. Sup. Ct. 1947) (refusing to substitute the judgment of the court for that of the corporation's board of directors as to whether dividends should be declared).

4. *See* A.P. Smith Mfg. Co. v. Barlow, 98 A.2d 581, 590 (N.J. 1953) (sustaining a corporation's charitable contribution to a privately supported educational institution where there was no evidence that the contribution was made indiscriminately or in furtherance of the personal objectives of corporate directors).

5. *See* Brehm v. Eisner, 746 A.2d 244, 264 (Del. 2000) (noting that a board of directors' business decisions will not be disturbed if they can be attributed to any rational business purpose in upholding the board's approval of a large severance package for the corporation's former president); *In re Disney*, 907 A.2d at 771 (finding that the former Disney board properly exercised its business judgment and did not violate any fiduciary duties when it elected Ovitz as president after being informed of who Ovitz was, the key terms of his employment agreement, and the reporting structure to which Ovitz had agreed).

(4) the director had no financial interest in the decision at issue.[6] Despite its ubiquity in the jurisprudence of corporate law, the Rule remains a doctrinal puzzle.[7] Scholars struggle towards a unified theory to justify the Rule's multiple applications, but this leads to doctrinal incoherence.[8]

The most compelling explanation of how the Rule ought to be conceptualized is the notion of the Rule as an abstention doctrine.[9] So conceived, the Rule cuts off litigation before the court engages in any substantive review of the board's decision.[10] As an abstention doctrine, the Rule serves its fundamental purpose of protecting corporations from the expense of suits that challenge decisions that are within the purview of a corporation's board of directors.[11] However, courts rarely

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6. *See* Stephen M. Bainbridge, *The Business Judgment Rule as Abstention Doctrine*, 57 VAND. L. REV. 83, 83 (2004) ("The [Rule] pervades every aspect of state corporate law, from the review of allegedly negligent decisions by directors, to self-dealing transactions, to board decisions to seek dismissal of shareholder litigation, and so on."); Meredith M. Brown & William D. Regner, *What's Happening to the Business Judgment Rule?*, INSIGHTS, Aug. 2003, at 2 ("Courts have traditionally deferred to the business judgment of directors, if the directors act in good faith, with loyalty to the corporation, and on an informed basis."); Melvin Aron Eisenberg, *The Divergence of Standards of Conduct and Standards of Review in Corporate Law*, 62 FORDHAM L. REV. 437, 441 (1993) (setting forth four conditions that must be met for the Rule to apply: (1) a judgment has been made, (2) the director has employed a reasonable decision-making process, (3) the decision has been made in subjective good faith, and (4) no financial conflicts of interest exist).

7. *See, e.g.*, FRANKLIN A. GEVURTZ, CORPORATION LAW 279-88 (2000) (summarizing cases that range from treating the Rule as akin to an ordinary negligence standard to cases that hold that the Rule precludes them from substantive review of business decisions); Bainbridge, *supra* note 6, at 84 ("[D]espite all of the attention lavished on it, the [Rule] remains poorly understood."); R. Franklin Balotti & James J. Hanks, Jr., *Rejudging the Business Judgment Rule*, 48 BUS. LAW. 1337, 1337-40 (1993) (noting the lack of consensus on the meaning of the [Rule]); Franklin A. Gevurtz, *The Business Judgment Rule: Meaningless Verbiage or Misguided Notion?*, 67 S. CAL. L. REV. 287, 287-88 (1994) (remarking on the lack of consensus as to what the Rule really is).

8. *See, e.g.*, Bainbridge, *supra* note 6, at 84 ("We lack a coherent and unified theory that explains why the rule exists and where its limits should be placed."); Kenneth B. Davis, Jr., *Once More, the Business Judgment Rule*, 2000 WIS. L. REV. 573, 573 ("[T]housands of pages of corporate law scholarship . . . have been devoted to these fundamental questions [regarding the Rule], yet we remain short of any broad consensus as to the answers.").

9. Bainbridge, *supra* note 6, at 87 ("[T]he [R]ule is better understood as a doctrine of abstention pursuant to which courts in fact refrain from reviewing board decisions unless exacting preconditions for review are satisfied.").

10. *See id.* at 128 ("If the [Rule] is framed as an abstention doctrine, however, judicial review is more likely to be the exception rather than the rule.").

11. *See* Gevurtz, *supra* note 7, at 306 (stating that even if a defendant prevails in a suit brought by shareholders, the litigation will be expensive); *cf.* Brehm v. Eisner, 746 A.2d 244, 265 (Del. 2000) (stating that Disney's board had an argument for firing Ovitz for cause but persuading the court to accept the argument would involve expensive litigation, distraction of executive time and company resources, lost opportunity costs, more bad

treat the Rule as an abstention doctrine, preferring to characterize it either as an evidentiary guideline or a standard of review.[12]

One major problem with courts' use of the Rule is that the justifications of the Rule now mostly focus on the need to protect the interests of the corporate directors rather than on protecting the interests of the corporation itself. Most legal scholars' discussions of the justifications of the Rule similarly focus on why directors must benefit from the Rule's protection rather than on why the Rule is necessary to protect the interests of corporations and their shareholders.[13]

The following discussion aims to cut through the doctrinal confusion that has arisen from courts' attempts to use the Rule to protect directors rather than corporations. In Part II.A, this Article illustrates how the Rule has been variously conceived as a presumption and as a standard of review. If the Rule is so understood, courts necessarily engage in substantive review of board decisions. In the end, courts generally defer to those decisions but only after the corporation has suffered the expense and reputational harms associated with protracted litigation. Thus, the Rule would better protect the interests of corporations if more consistently applied as an abstention doctrine. In Part II.B, this Article critiques existing justifications for the Rule, all of which focus on the need to protect directors rather than on the need to protect corporations. Concluding that all of these justifications are unsatisfactory, the Article then introduces a new substantive justification for the Rule: the Rule is necessary to protect corporations only when the discovery process attendant to litigation would compel the corporation to disclose its prospective business plans.

A. *Confusion as to the Nature of the Rule*

Part of the difficulty that courts face in applying the Rule is that there is no agreement as to what it is, except that all seem agreed that the Rule is not a rule.[14] In *Aronson v. Lewis*, the Delaware Supreme

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publicity, and an outcome that was uncertain at best and, at worst, could have resulted in damages against the company).

12. *See* discussion *infra* Part II.A.

13. *See* discussion *infra* Part II.B.1-2.

14. *In re* Walt Disney Co. Derivative Litig., 907 A.2d 693, 746-47 (Del. Ch. 2005), *aff'd*, 906 A.2d 27 (Del. 2006) ("The [Rule] is not actually a substantive rule of law . . . ."); Douglas M. Branson, *The Rule that Isn't a Rule—The Business Judgment Rule*, 36 VAL. U. L. REV. 631, 631 (2002) ("The much misunderstood [Rule] is not a 'rule' at all.").

Court described the Rule essentially as an evidentiary presumption in favor of directors, characterizing the Rule as

> a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company. Absent an abuse of discretion, that judgment will be respected by the courts. The burden is on the party challenging the decision to establish facts rebutting the presumption.[15]

The presumption applies only when there is no evidence of fraud, bad faith, or self-dealing on the part of the directors.[16] When the plaintiff fails to rebut the presumption, "she is not entitled to any remedy, be it legal or equitable, unless the transaction constitutes waste."[17] However, although the Delaware Supreme Court repeatedly states that the Rule is really an evidentiary presumption,[18] the strength of the presumption is unclear.[19] Because a plaintiff always bears the evidentiary burden, it

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15. 473 A.2d 805, 812 (Del. 1984) (citations omitted); *see* Branson, *supra* note 14, at 632 ("Most generally, the [Rule] acts as a presumption in favor of corporate managers' actions."). The *Aronson* court relied on two earlier cases, *Kaplan v. Centex Corp.*, 284 A.2d 119, 124 (Del. Ch. 1971), and *Robinson v. Pittsburgh Oil Refining Corp.*, 126 A. 46, 48 (Del. Ch. 1924), in support of its interpretation of the Rule as a "presumption." *See* Balotti & Hanks, *supra* note 7, at 1341 ("The reader of these opinions is left with the suspicion that the term *presumption* in the early opinions was introduced in its colloquial rather than its evidentiary sense and then carried forward without further consideration."). But the presumption approach to the Rule has also been adopted by other courts. *See, e.g.*, Panter v. Marshall Field & Co., 646 F.2d 271, 293 (7th Cir. 1981) ("'When [directors] act in good faith, they enjoy a presumption of sound business judgment, reposed in them as directors, which courts will not disturb if any rational business purpose can be attributed to their decisions.'" (quoting Panter v. Marshall Field & Co., 486 F. Supp. 1168, 1194 (N.D. Ill. 1980))); Treadway Cos. v. Care Corp., 638 F.2d 357, 382 (2d Cir. 1980) ("Under the [Rule], directors are presumed to have acted properly and in good faith . . . ."); Johnson v. Trueblood, 629 F.2d 287, 292 (3d Cir. 1980) ("[I]f actions are arguably taken for the benefit of the corporation, then the directors are presumed to have been exercising their sound business judgment . . . ."); Auerbach v. Bennett, 393 N.E.2d 994, 1000 (N.Y. 1979) ("The authority and responsibilities vested in corporate directors both by statute and decisional law proceed on the assumption that inescapably there can be no available objective standard by which the correctness of every corporate decision may be measured, by the courts or otherwise."); 1 DENNIS J. BLOCK ET AL., THE BUSINESS JUDGMENT RULE: FIDUCIARY DUTIES OF CORPORATE DIRECTORS 22-24 (5th ed. 1998) (citing cases from twenty-five jurisdictions other than Delaware where courts have treated the Rule as a presumption in favor of a board having acted with due care).

16. *In re Disney*, 907 A.2d at 747 (citing Grobow v. Perot, 539 A.2d 180, 187 (Del. 1988)).

17. *Id.*

18. *See* 1 BLOCK ET AL., *supra* note 15, at 20-21 (citing over twenty cases from the Delaware Supreme Court reiterating its view that the Rule is a presumption).

19. *See id.* at 25-32 (discussing the nature of the presumption and the effect on litigation when that presumption is overcome); Williams v. Geier, 671 A.2d 1368, 1378 (Del. 1996) ("Only by demonstrating that the Board breached its fiduciary duties may the

is not clear how treating the Rule as a presumption adds anything to that burden.[20]

Kenneth Davis defines the Rule quite lucidly as "a doctrine holding that directors of corporations should not be liable for what amounts to a good faith exercise of business judgment, even if other boards might have reached a contrary conclusion."[21] The Rule is thus a means of allocating the risk of business judgments to shareholders rather than directors.[22] This seems straightforward enough, but once again it is not clear how courts are to apply the Rule so understood. As Davis sets out the Rule, it could simply mean that boards will not be liable for a good faith business decision, even if that decision has disastrous consequences for the corporation, as long as the board's decision was not a negligent one.

Confusion over the applicable standard is exacerbated because, as Melvin Eisenberg points out, there is a divergence between the standard of conduct (our expectations of directors) and the standard of review that a court will apply in determining whether a board's conduct gives rise to liability.[23] In setting out the standard of care, the *Model Business Corporation Act of 1998* states that directors, in using their business judgment, are to exercise "the care an ordinarily prudent person in a like position would exercise under similar circumstances."[24]

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presumption of the [Rule] be rebutted . . . ."). *But see* Smith v. Van Gorkom, 488 A.2d 858, 872-73 (Del. 1985) (requiring that plaintiffs establish the board acted with *gross negligence* in order to rebut the Rule's presumption).

20. *See* Gevurtz, *supra* note 7, at 291-92 (arguing that the presumption is nothing more than a burden of proof and noting that "the proposition that the plaintiff, in any context, has the burden of proving his or her prima facie case is a rule with which every first-year law student should be familiar").

21. Davis, *supra* note 8, at 573.

22. *Id.* at 573-74.

23. Eisenberg, *supra* note 6, at 467 (concluding that the standard of conduct for directors is that they must act in good faith and in the interests of the corporation, but standards of review may be relaxed, intermediate, or demanding, depending on the nature of the business judgment being reviewed); *see* 1 BLOCK ET AL., *supra* note 15, at 1-4 ("[T]he duty of care requires that directors exercise the care that a person in a like position would exercise under similar circumstances . . . . The [Rule] is a standard of judicial review for director conduct, not a standard of conduct."); William T. Allen et al., *Realigning the Standard of Review of Director Due Care with Delaware Public Policy: A Critique of* Van Gorkom *and Its Progeny as a Standard of Review Problem*, 96 NW. U. L. REV. 449, 450-51 (2002) (noting that in corporation law the standard of conduct and standard of review diverge in the area of due care).

24. MODEL BUS. CORP. ACT § 8.30(a)(2) (1998); *see* Branson, *supra* note 14, at 631 ("The standard of conduct is not 'slight care,' or 'gross negligence,' or anything other than due care."). This standard of care has been criticized as inappropriate given how boards work. *See* Bayless Manning, *The Business Judgment Rule and the Director's Duty of Attention: Time for Reality*, 39 BUS. LAW. 1477, 1493 (1984).

The Delaware Supreme Court has stated that the standard of care is "that amount of care which ordinarily careful and prudent men would use in similar circumstances."[25] Few courts have held directors liable for breaches of this standard of care, but there is a considerable range in the standard of review applied.[26] Standards of review applied under the Rule include "good faith, business judgment, prudence, negligence, gross negligence, waste, and fairness."[27] New York courts have stated standards ranging from ordinary negligence[28] to "good faith," that is, directors will not be liable as long as they thought their actions would benefit the company.[29]

The Delaware courts also have not spoken with one voice when it comes to determining which standard of review applies. While former Chancellor William T. Allen contends that the proper standard is "gross negligence,"[30] he concedes that courts do not seem to apply a

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25. Graham v. Allis-Chalmers Mfg. Co., 188 A.2d 125, 130 (Del. 1963).

26. Gevurtz, *supra* note 7, at 295 (stating the dominant interpretation of the Rule is as a standard of culpability but noting that "courts and commentators disagree on what the standard is or should be").

27. Eisenberg, *supra* note 6, at 438. Eisenberg suggests that different standards of review might be appropriate depending on whether the relief sought is the imposition of liability on a director or merely injunctive relief. *Id.* at 446. Scholarly arguments in support of such a rationale for different standards under the Rule date back to at least 1984, but Eisenberg can point to only "modest support" in case law for any link between the type of relief sought and the standard applied. *See id.* at 445-47 ("[I]t is not clear that the employment of different standards of review in liability and validity contexts has caught hold in the context of ordinary business decisions."); Gevurtz, *supra* note 7, at 290-94 (arguing that treating the Rule as an ordinary negligence standard renders the Rule tautological).

28. *See* Litwin v. Allen, 25 N.Y.S.2d 667, 699 (N.Y. Sup. Ct. 1940) ("Unless we are to do away entirely with the doctrine that directors of a bank are liable for negligence in administering its affairs liability should be imposed in connection with this transaction."). *But see* Franklin A. Gevurtz, *Earnings Management and the Business Judgment Rule: An Essay on Recent Corporate Scandals*, 30 WM. MITCHELL L. REV. 1261, 1266 (2004) (suggesting that the conduct at issue in *Litwin* actually involved gross negligence).

29. *See, e.g.*, Gevurtz, *supra* note 7, at 297 (citing New York cases using a bad faith standard of review).

30. Allen et al., *supra* note 23, at 449. Allen and his coauthors criticize the *Van Gorkom* decision for giving "insufficient weight to the substantive policy judgments underlying the gross negligence standard of review that governs whether corporate directors should be found liable for breaching their duty of care." *Id.* (criticizing *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1983)). Allen then praises the Delaware Supreme Court's decision in *Brehm v. Eisner*, 746 A.2d 244 (Del. 2000), for holding that courts should review directors adherence to their duty of care only for "irrationality," the functional equivalent of a gross negligence standard. *Id.* at 457; *see In re* Walt Disney Co. Derivative Litig., 907 A.2d 693, 748 (Del. Ch. 2005), *aff'd*, 906 A.2d 27 (Del. 2006) ("[T]he appropriate standard for determining liability is widely believed to be gross negligence, but a single Delaware case has held that ordinary negligence would be the appropriate standard." (citing Rabkin v. Philip A. Hunt Chem. Corp., 1987 WL 28436, at *1-3 (Del. Ch. Dec. 17, 1987) (employing an ordinary negligence standard) (footnotes omitted))).

gross negligence standard of review consistently to duty-of-care cases that implicate the Rule.[31]

Stephen Bainbridge contends that treating the Rule as a standard of review leads to erroneous decisions, and he therefore prefers to conceptualize the rule as an abstention doctrine "pursuant to which courts in fact refrain from reviewing board decisions unless exacting preconditions for review are satisfied."[32] Lyman Johnson has similarly argued that the Rule is best understood as a "narrow-gauged policy of non-review."[33] Johnson thus proposes a "modest" Rule as follows: "'[W]here money damages or equitable relief is sought, the [Rule] is a judicial policy of not reviewing the substantive merits of a board of directors' business decision for the purpose of determining whether directors breached or fulfilled their duty of due care.'"[34] Bainbridge and Johnson's reading of the Rule would greatly expand its scope[35] because they would have courts abstain from engaging in substantive review of board decisions where the directors can show that they had no interest in the challenged transactions, did not commit waste, and followed appropriate decision-making procedures.[36]

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31. *See* Aronson v. Lewis, 473 A.2d 805, 812 n.6 (Del. 1984) ("[D]irector liability is predicated on a standard which is less exacting than simple negligence."). *But see* Allen et al., *supra* note 23, at 458-61 (decrying recent decisions such as *Van Gorkom* and *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345 (Del. 1993), as improperly imposing liability on directors based on a negligence standard).

32. Bainbridge, *supra* note 6, at 87.

33. Lyman Johnson, *The Modest Business Judgment Rule*, 55 BUS. LAW. 625, 625 (2000) (emphasis omitted).

34. *Id.* at 631.

35. *See* Bainbridge, *supra* note 6, at 87 (noting that courts adopting the abstention approach to the Rule would not review the substance of directors' decisions unless the plaintiff can meet the "very heavy burden of rebutting [the] presumption" against review). Johnson's approach to the Rule is similar. He argues that any breach of the duty to act with due care is a breach of fiduciary duty that exposes the director to liability for all damages proximately caused by the breach, absent statutory protections against such liability. Johnson, *supra* note 33, at 634 (referencing DEL. CODE ANN. tit. 8, § 102(b)(7) (2001), which allows corporations to limit liability for any breach of the duty of care by its directors). However, Johnson contends that the Rule precludes a court's *substantive* review of a board's business decisions whether or not the duty of care was violated. *Id.* at 634-35. Like Bainbridge, Johnson criticizes the Delaware Supreme Court's decisions in *Cede & Co.*, 634 A.2d 345, and *Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1156 (Del. 1995), for engaging in substantive review of the board's decisions as part of an inquiry into the board's exercise of due care. *Id.* at 645-50.

36. *See* Bainbridge, *supra* note 6, at 128 (contending that courts should review facts not to determine the quality of the decision or whether the board exercised reasonable care but whether the decision-making process was tainted by self-dealing, fraud, or illegality).

However, courts have conceived the Rule as a form of abstention doctrine in a relatively small number of prominent cases.[37] When they do so, courts justify abstention in terms of the standard defenses of the Rule, explored in Part II.B. In *Shlensky v. Wrigley*, the court relied on the "sovereignty rationale," contending that because directors are chosen to make business judgments, their decisions cannot be challenged unless tainted by fraud.[38] In refusing to review Henry Ford's decision to expand his company's manufacturing facilities in *Dodge v. Ford Motor Co.*, the court noted that "judges are not business experts," another common justification for the Rule.[39] Conceiving the Rule as an abstention doctrine, rather than as a standard or review or a presumption, thus has some support in the case law and also makes sense in terms of the standard justifications of the Rule, but it is not the dominant approach of the courts.[40]

Given the doctrinal confusion regarding the nature of the Rule, it is not surprising that courts do not apply the Rule consistently. But one reason there is no agreement on what standard of review the Rule establishes is that the Rule is deployed in too many diverse contexts, and it would be inappropriate to apply the same standard of review in

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37. *Cf. id.* at 95-102 (citing Brehm v. Eisner, 746 A.2d 244 (Del. 2000), and criticizing the decision of the Delaware Supreme Court in *Cede & Co.*, 634 A.2d at 345, for engaging in substantive review of the board's decision-making process to determine whether it violated its duty of care); Shlensky v. Wrigley, 237 N.E.2d 776 (Ill. App. Ct. 1968); Dodge v. Ford Motor Co., 170 N.W. 668 (Mich. 1919); Leslie v. Lorillard, 18 N.E. 363, 365 (N.Y. 1888); Kamin v. Am. Express Co., 383 N.Y.S.2d 807 (N.Y. Sup. Ct.), *aff'd*, 387 N.Y.S.2d 993 (N.Y. App. Div. 1976).

38. 237 N.E.2d at 778-80.

39. 170 N.W. at 684. The same rationale was also deployed when the *Kamin* court stated that "[t]he directors' room rather than the courtroom is the appropriate forum for thrashing out purely business questions." 383 N.Y.S.2d at 810-11.

40. The American Law Institute (ALI) takes a complementary approach in its *Principles of Corporate Governance: Analysis and Recommendations*, in which it characterizes the Rule as establishing a "safe harbor" for directors accused of breaching their duty of care if they: (1) are disinterested, (2) are reasonably informed with respect to the challenged business judgment, and (3) rationally believe that the judgment is in the best interests of the corporation. 1 PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 4.01(c) (1992); *see, e.g.*, Branson, *supra* note 14, at 636 ("By contrast [with the Delaware formulation of the Rule], the ALI version is a safe harbor."); Balotti & Hanks, *supra* note 7, at 1338-39 ("[I]n the . . . ALI, there is a [Rule], labelled a 'safe harbor,' the satisfaction of which is a complete defense to an alleged breach of the standard of conduct . . . ."). This safe-harbor approach would seem to be equivalent in its effects to the notion of the Rule as an abstention doctrine: assuming the board followed the proper decision-making procedures and acted in good faith, a court should abstain from review of the substance of board decisions.

all cases.[41] This Article takes a closer look at the sorts of decisions that are protected by the Rule and provides a general theory that can explain when boards should be accorded the Rule's protection and when the shareholding public is entitled to hold directors to a standard of culpability more in line with their expectations for conduct by business decision makers.

Conceiving the Rule as an abstention doctrine has the advantage of providing for a more principled deployment of the Rule, as abstention shuts down the litigation at a very early stage and thus protects corporations from dissipation of resources and reputational harm that could arise in the discovery process. However, this Article proposes that such protections are only appropriate when the challenged decisions relate to the corporation's prospective business plans, the disclosure of which would interfere with the corporation's ability to pursue such plans and thus do irreparable harm to the firm and its shareholders.

B. Justifications for the Rule

Courts and legal scholars rely on three kinds of justification for the Rule. First, courts defer to the judgment of corporate boards based on their superior expertise and knowledge in business matters generally and in the affairs of their businesses in particular.[42] We trust the institutional competence of corporate boards over that of courts when it comes to the boards' business decisions.[43] In addition, concerns regarding judicial economy and the overburdened courts speak in favor of keeping challenges to corporate boards' decisions out of the courts.[44] A second justification for the [Rule] is that corporate

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41. *See* Eisenberg, *supra* note 6, at 437-38 (arguing that courts have applied and should apply different standards of review depending on the nature of the alleged breach by directors).

42. *See, e.g.*, FDIC v. Stahl, 89 F.3d 1510, 1517 (11th Cir. 1996) ("'[D]irectors are, in most cases, more qualified to make business decisions than are judges.'" (quoting Int'l Ins. Co. v. Johns, 874 F.2d 1447, 1458 n.20 (11th Cir. 1989))); *Dodge*, 170 N.W. at 684 (refusing to interfere with Henry Ford's plan to invest Ford's surplus capital in a new manufacturing plant on the ground that "judges are not business experts").

43. *See* W. Point-Pepperell, Inc. v. J.P. Stevens & Co. (*In re* J.P. Stevens & Co. S'holders Litig.), 542 A.2d 770, 780 (Del. Ch. 1988) ("'Because businessmen and women are correctly perceived as possessing skills, information and judgment not possessed by reviewing courts[,] ... [the] courts have long been reluctant to second-guess [boards' business] decisions when they appear to have been made in good faith.'" (quoting Solash v. Telex Corp., 1988 WL 3587, at *8 (Del. Ch. Jan. 19, 1988))).

44. *See, e.g.*, Branson, *supra* note 14, at 637-38 ("[A] policy behind the rule is conservation of the judicial resource. The [Rule] is a filter that enables courts to easily screen out non-meritorious challenges to the actions of directors and executives.").

executives would be less inclined to take risks in pursuing aggressive strategies that promote economic growth if they could be held personally liable every time a court, ruling in hindsight, considered those strategies ill-advised.[45]

Finally, the Rule is also defended based on a freedom-of-contract/corporate-democracy theory, according to which shareholders agree to delegate decision-making power to corporate boards.[46] In the interests of protecting the financial resources of the corporation from dissipation in litigation, the decisions of a corporate board are subject to judicial review only in limited cases involving fraud, self-dealing, or decisions so egregious they can only be characterized as waste.[47]

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45. *See, e.g.*, Joy v. North, 692 F.2d 880, 886 (2d Cir. 1982) (noting that "potential profit often corresponds to the potential risk" and recognizing the dangers of hindsight bias). Chancellor Allen and his coauthors break down these first two justification of the Rule as follows:

> (1) [D]irectors must often make decisions in an environment of imperfect (that is, limited or incomplete) information; (2) the risk of liability under the applicable standard of conduct for assuming a given corporate role may dwarf the incentives for assuming the role; (3) if the risk of liability is disproportionate to the directors' incentives for service, directors may avoid making economically valuable decisions that might subject them to litigation risk; (4) courts are ill-equipped to determine after the fact whether a particular business decision was reasonable in the circumstances confronting the corporation; and (5) institutional and prudential considerations sometimes counsel judicial deference to the corporate decision maker.

Allen et al., *supra* note 23, at 451-52; *see* Frances T. v. Vill. Green Owners Ass'n, 723 P.2d 573, 582 n.14 (Cal. 1986) ("[D]irectors should be given wide latitude in their handling of corporate affairs because the hindsight of the judicial process is an imperfect device for evaluating business decisions.").

46. *See* Allen et al., *supra* note 23, at 456 ("Directors are elected, and can be removed, by shareholders. Where stockholders are able to change the board because of inadequate performance, there is less reason for courts to intervene and police whether the directors are behaving reasonably.").

47. LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION 46 (2004) (noting cases in which actual waste is found have been described as akin to the Loch Ness Monster—"so rare as to be possibly nonexistent"); *see In re* Walt Disney Co. Derivative Litig., 907 A.2d 693, 748 (Del. Ch. 2005), *aff'd*, 906 A.2d 27 (Del. 2006) ("Corporate waste is very rarely found in Delaware courts because the applicable test imposes such an onerous burden upon a plaintiff . . . ."); Steiner v. Meyerson, Civ. A. No. 13139, 1995 WL 441999, at * 5 (Del. Ch. July 19, 1995) ("There surely are cases of fraud; of unfair self-dealing and, much more rarely negligence. But rarest of all—and indeed, like Nessie, possibly non-existent—would be the case of disinterested business people making non-fraudulent deals (non-negligently) that meet the legal standard of waste!"). The *Brehm* court describes the test for waste as "stringent," that is, "'an exchange that is so one sided that no business person of ordinary, sound judgment could conclude that the corporation has received adequate consideration.'" Brehm v. Eisner, 746 A.2d 244, 263 (Del. 2000) (quoting *In re Disney*, 907 A.2d at 748).

None of these defenses of the Rule is satisfying. The justifications are unconvincing because we do not protect similarly situated decision makers with similar common law rules of deference.[48] In addition, the justifications fail to the extent that they explain the Rule in terms of the need to protect directors who are already sheltered from liability through statutory means.[49] But most of all, these justifications fail because they focus on the need to protect directors rather than on the need to protect the vital interests of the corporation against litigation threats that are unlikely to further those interests.

1. Deference to Boards' Business Expertise

The cases are legion in which courts proclaim the virtues of the Rule in allocating responsibility for business decisions to professional businessmen rather than to judges whose area of expertise is law.[50] But legal scholars have pointed out several weaknesses in this justification for the Rule. For one thing, judges are often called upon to rule in cases involving factual scenarios that require professional expertise.[51] But courts do not routinely defer to the medical judgment of doctors or

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48. *See* Gevurtz, *supra* note 7, at 305, 312-14 (arguing that the decisions made by business directors do not deserve any more deference than medical or legal decisions, which also require the decision maker to take risks or which might result in a loss).

49. *See infra* Part II.B.2.

50. *See, e.g.*, Auerbach v. Bennett, 393 N.E.2d 994, 1000 (N.Y. 1979) (supporting the Rule on the ground it prevents courts from becoming enmeshed in complex decision-making processes that they are ill-equipped to handle); Dodge v. Ford Motor Co., 170 N.W. 668, 684 (Mich. 1919) (refusing to question Ford's decision to expand its manufacturing facilities on the ground that "judges are not business experts"); Shlensky v. Wrigley, 237 N.E.2d 776, 779 (Ill. App. Ct. 1968) ("'[I]t is not [the court's] function to resolve for corporations questions of policy and business management. The directors are chosen to pass upon such questions and their judgment unless shown to be tainted with fraud is accepted as final.'" (quoting Davis v. Louisville Gas & Elec. Co., 142 A. 654, 659 (Del. Ch. 1928) (emphasis omitted))). For a novel scholarly defense of this rationale, see Manning, *supra* note 24, at 1491 (contending that the linear reasoning characteristic of legal thought is not well suited to business decision making).

51. *See* Davis, *supra* note 8, at 581 ("Can anyone seriously argue that surgeons in the operating room, lawyers in the midst of a heated trial, or accountants up against a closing deadline are not also called upon to make snap judgments in response to circumstances that may be difficult to recreate in a courtroom years later? Nonetheless, our legal system is quite comfortable relying on the device of litigation to review . . . the quality of these professionals' performances . . . ."); Kent Greenfield & John E. Nilsson, *Gradgrind's Education: Using Dickens and Aristotle to Understand (and Replace?) the Business Judgment Rule*, 63 BROOK. L. REV. 799, 825-26 (1997) (characterizing the justification as "disingenuous"); Dale A. Oesterle & Alan R. Palmiter, *Judicial Schizophrenia in Shareholder Voting Cases*, 79 IOWA L. REV. 485, 572 (1994) (dismissing the rationale as an "old adage").

the engineering expertise of product designers.[52] Instead, they rely on expert testimony.[53] There is no reason why, aided by expert witnesses, courts could not apply the same standard of liability to business decision makers as they do to decision makers in other fields requiring professional expertise.

Moreover, as one commentator has noted, "[D]irectors, at least the outside directors, bring to the table no particular business expertise or experience, but instead general qualities such as common sense, integrity, and a track record of accomplishment. These are, not surprisingly, the same qualities that characterize most members of the judiciary."[54] If anything, the expertise of businessmen poses fewer challenges for courts than does the expertise of other professionals who do not enjoy the special protections accorded by the Rule.

Indeed, it may be true as a general rule that judges are less qualified than professional businessmen to evaluate substantive business decisions taken by a corporate board.[55] However, there is no reason to think that the general rule should be maintained in jurisdictions such as Delaware and the New York State Supreme Court's Commercial Division in which the judges have remarkable and varied commercial expertise.[56] As more states set up commercial

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52. *See* Gevurtz, *supra* note 7, at 288 ("[T]he standards of ordinary negligence sufficient to create liability for automobile drivers, doctors, lawyers, and just about anyone else except children are not sufficient in an action on behalf of the corporation against its directors."). Gevurtz provides a more extended argument for why the ordinary negligence standard could apply to business decisions just as it does to other decisions made by professionals. *Id.* at 305-12.

53. Davis, *supra* note 8, at 581; *see* FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 94 (1991) ("The standard justifications . . . do not explain why the same judges who decide whether engineers have designed the compressors on jet engines properly, whether the farmer delivered pomegranates conforming to the industry's specifications, and whether the prison system adversely affects the mental states of prisoners cannot decide whether a manager negligently failed to sack a subordinate who made improvident loans."); Hal R. Arkes & Cindy A. Schipani, *Medical Malpractice v. the Business Judgment Rule: Differences in Hindsight Bias*, 73 OR. L. REV. 587, 613-17 (1994) (highlighting differences between cases in the areas in medical malpractice and corporate law).

54. Davis, *supra* note 8, at 581 (footnote omitted).

55. *See* FDIC v. Stahl, 89 F.3d 1510, 1517 (11th Cir. 1996) (noting that directors are usually more qualified than judges to make business decisions).

56. *See* Ehud Kamar, *A Regulatory Competition Theory of Indeterminacy in Corporate Law*, 98 COLUM. L. REV. 1908, 1925 (1998) (noting the Delaware Court of Chancery's experience in corporate adjudication and reputation for proficiency in corporate matters); *see also* ABA Ad Hoc Comm. on Bus. Courts, *Business Courts: Towards a More Efficient Judiciary*, 52 BUS. LAW. 947, 955-56 (1997) (stating that the skilled judges and efficiency of Delaware's Court of Chancery are often credited with spawning the push for business courts elsewhere); Bernard S. Black, *Is Corporate Law Trivial?: A Political and Economic Analysis*, 84 NW. U. L. REV. 542, 590 (1990) ("Delaware's governor, mindful of the

courts presided over by judges with special business expertise, this justification of the Rule looks more and more archaic.[57]

Oddly enough, Frank Easterbrook and Daniel Fischel defend the Rule based on the fact that the discovery process often provides judges with *more* information about challenged decisions than the directors actually had at the time the challenged decisions were made.[58] The Rule thus prevents judges with a more complete picture of the circumstances from faulting directors for a hastily made decision.[59] But the Rule is a rather extreme way to address the problem of hindsight bias. Indeed, courts already seem well aware of the danger of hindsight bias.[60] In short, this rationale for the Rule is rather hard to defend in the very jurisdictions that have done the most to help develop it.

Finally, this justification for the Rule is especially misplaced when boards of directors rely on expert opinions in making their business decisions, as they are permitted to do, for example, under Delaware law.[61] When boards rely on expert opinions, they concede

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value of corporate charters, often deliberately appoints judges with corporate experience."); William T. Quillen & Michael Hanrahan, *A Short History of the Delaware Court of Chancery—1792-1992*, 18 DEL. J. CORP. L. 819, 841-65 (1993) (outlining the Delaware Court of Chancery's history and development from 1910 until present day in light of the advent of corporate litigation); Larry Smith, *All Systems Go: New York Business Courts Celebrate a First Anniversary*, INSIDE LITIG., Jan. 1997, at 1, 1-2 (stating that New York's Commercial Division is the forum of choice for commercial litigation because of its management and judicial expertise, while general court system judges neither enjoy nor understand the issues of complex commercial litigation).

57. *See* Mitchell L. Bach & Lee Applebaum, *A History of the Creation and Jurisdiction of Business Courts in the Last Decade*, 60 BUS. LAW. 147, 151-52 (2004) (discussing the potential creation and jurisdiction of business courts in Colorado, Delaware, Florida, Georgia, Illinois, Maryland, Massachusetts, Michigan, Nevada, New Jersey, New York, North Carolina, Oklahoma, Pennsylvania, and Rhode Island).

58. *See* EASTERBROOK & FISCHEL, *supra* note 53, at 100 ("Judges also are accustomed to deciding cases on full records and may be too quick to blame managers who act—as often they should—in haste or on incomplete information.").

59. *Id.*

60. *See In re* Walt Disney Co. Derivative Litig., 731 A.2d 342, 362 (Del. Ch. 1998), *aff'd in part, rev'd in part*, Brehm v. Eisner, 746 A.2d 244 (Del. 2000) ("It is the essence of the [Rule] that a court will not apply 20/20 hindsight to second guess a board's decision, except 'in rare cases [where] a transaction may be so egregious on its face that board approval cannot meet the test of business judgment.'" (quoting Aronson v. Lewis, 473 A.2d 805, 815 (Del. 1984))).

61. DEL. CODE. ANN. tit. 8, § 141(e) (2001) ("A member of the board of directors . . . shall . . . be fully protected in relying in good faith upon . . . such information, opinions, reports or statements presented to the corporation by . . . any other person as to matters the member reasonably believes are within such other person's professional or expert competence . . . ."); *see* Brehm v. Eisner, 746 A.2d 244, 261 (Del. 2000) ("The Old Board [was] entitled to the presumption that it exercised proper business judgment, including proper reliance on the expert." (footnote omitted)).

that they lack expertise relevant to the business judgment in question. Once they have had the opportunity to read the relevant experts' reports and to hear testimony from qualified witnesses, judges are as well-qualified as directors to assess the quality of boards' decisions on matters in which those boards relied on expert opinions.

2. The Need To Protect Entrepreneurial Risk Takers

The American Law Institute's (ALI) *Principles of Corporate Governance* provides as the main justification of the Rule the need "to protect directors and officers from the risks inherent in hindsight reviews of their unsuccessful decisions, and to avoid the risk of stifling innovation and venturesome business activity."[62] Numerous courts have similarly recognized the need to shield directors from liability for the risky ventures necessary for commercial development.[63] Scholars and courts have expressed concern that qualified businesspeople would refuse to serve on boards if their risky decisions were not

62. 1 PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS, *supra* note 40, § 4.01 cmt. d. Whether the Rule protects both officers and directors or only directors is hotly contested among scholars and in the courts today. *See* Lyman P.Q. Johnson, *Corporate Officers and the Business Judgment Rule*, 60 BUS. LAW. 439, 440 (2005) ("[The Rule] does not and should not be extended to corporate officers in the same broad manner in which it is applied to directors."). The issue is at the heart of plaintiffs' efforts to hold certain Disney directors liable as officers when they acted in their capacities as corporate officers of Disney in connection with the Ovitz litigation. *See* Appellants' Opening Brief at 36, *In re* Walt Disney Co. Derivative Litig., 906 A.2d 27 (Del. 2006) (No. 411, 2005), 2005 WL 2777912 ("[T]he [Rule] does not apply to Eisner or Litvack acting as officers or to Russell acting as Eisner's personal 'gratuitous agent.'"); Answering Brief of Non-Ovitz Defendants-Below, Appellees at 55, *In re* Disney, 906 A.2d 27 (No. 411, 2005), 2005 WL 3452042 (arguing that both numerous dicta and strong policy considerations suggest that the Rule should apply to both officers and directors). The Delaware Supreme Court refused to address the issue in the Disney litigation, finding that it was procedurally barred. *In re Disney*, 906 A.2d at 46 n.38.

63. *See, e.g.*, 1 BLOCK ET AL., *supra* note 15, at 12-13 (citing cases); Joy v. North, 692 F.2d 880, 886 (2d Cir. 1982) ("[B]ecause potential profit often corresponds to the potential risk, it is very much in the interest of shareholders that the law not create incentives for overly cautious corporate decisions."); Gagliardi v. Trifoods Int'l, Inc., 683 A.2d 1049, 1052 (Del. Ch. 1996) ("Shareholders don't want (or shouldn't rationally want) directors to be risk averse. Shareholders' investment interests . . . will be maximized if corporate directors and managers honestly assess risk and reward and accept for the corporation the highest risk adjusted returns available that are above the firm's cost of capital."); *In re* Walt Disney Co. Derivative Litig., 907 A.2d 693, 698 (Del. Ch. 2005), *aff'd*, 906 A.2d 27 ("Should the Court apportion liability based on the ultimate outcome of decisions taken in good faith by faithful directors or officers, those decision-makers would necessarily take decisions that minimize risk, not maximize value."); *see also* Allen et al., *supra* note 23, at 449 ("[D]eference [to business decisions] furthers important public policy values and underscores the social utility of encouraging corporate directors to make decisions that may create corporate wealth but that are also risky.").

protected by the Rule.[64] Or, even if they agreed to serve on boards, they would become risk averse and investors would suffer.[65]

However, empirical evidence to support this concern is lacking. While corporate directors recently have had to dig into their own pockets to pay damages in connection with the spectacular collapses of Enron and WorldCom,[66] those cases involved criminal wrongdoing and

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64. *See* Air Line Pilots Ass'n, Int'l v. UAL Corp., 717 F. Supp. 575, 582 (N.D. Ill. 1989), *aff'd*, 897 F.2d 1394 (7th Cir. 1990) ("The [Rule] encourages competent individuals to become directors who otherwise might decline for fear of personal liability."); Allen et al., *supra* note 23, at 449 ("Highly qualified directors may also avoid service if they face liability risks that are disproportionate to the benefits of service."); Davis, *supra* note 8, at 574 ("Why would directors enter into [risky business] ventures if they might be called upon to underwrite some of the losses arising from unfortunate outcomes while the profits from fortunate outcomes flow to the shareholders?"); Eisenberg, *supra* note 6, at 437-38 ("Perhaps standards of conduct and standards of review in corporate law would always be identical in a world in which information was perfect, the risk of liability for assuming a given corporate role was always commensurate with the incentives for assuming the role, and institutional considerations never required deference to a corporate organ. In the real world, however, these conditions seldom hold . . . .").

65. Chancellor Allen articulated this concern most colorfully:

> Corporate directors of public companies typically have a very small proportionate ownership interest in their corporations and little or no incentive compensation. Thus, they enjoy (as residual owners) only a very small proportion of any "upside" gains earned by the corporation on risky investment projects. If, however, corporate directors were to be found liable for a corporate loss from a risky project on the ground that the investment was too risky (foolishly risky! stupidly risky! egregiously risky!—you supply the adverb), their liability would be joint and several for the whole loss (with I suppose a right of contribution). Given the scale of operation of modern public corporations, this stupefying disjunction between risk and reward for corporate directors threatens undesirable effects. Given this disjunction, only a very small probability of director liability based on "negligence", "inattention", "waste", etc., could induce a board to avoid authorizing risky investment projects to any extent! Obviously, it is in the shareholders' economic interest to offer sufficient protection to directors from liability for negligence, etc., to allow directors to conclude that, as a practical matter, there is no risk that, if they act in good faith and meet minimal proceduralist standards of attention, they can face liability as a result of a business loss.

Gagliardi, 683 A.2d at 1052.

66. *See, e.g.*, Stephanie Armour, *Enron Woes Reverberate Through Lives: Many Saw Retirement Plans Evaporate with Stock Price*, USA TODAY (Wash., D.C.), Jan. 26, 2006, at 1B (noting the $85 million settlement with certain Enron officers, directors, and administrative committee members); G. Jeffrey MacDonald, *Now, Execs Pay for Firm's Sins*, CHRISTIAN SCI. MONITOR (Boston), Jan. 31, 2005, at 14 (noting the former WorldCom Inc. directors personally agreed to pay $18 million as part of a $54 million settlement with shareholders and ten former Enron directors agreed to pay $13 million of their own money as part of a $168 million settlement with shareholders); Gretchen Morgenson, *Sticky Scandals, Teflon Directors*, N.Y. TIMES, Jan. 29, 2006, § 3, at 1 ("A year ago, 10 Enron directors, including eight outside directors, agreed to pay $13 million out of their own pockets to shareholders without admitting or denying any liability.").

are hardly representative.[67] Awards against negligent directors (as opposed to directors who are wholly inattentive or engaged in interested transactions in breach of their duty of loyalty and who thus would not be entitled to the Rule's protections) are actually exceedingly rare.[68]

It may be that the Rule is the proper mechanism for preventing such awards and that it is necessary to encourage desirable risk-taking activities by corporate managers.[69] However, it is not clear that anything more than a negligence standard is needed to protect entrepreneurial risk taking. As Franklin Gevurtz has pointed out:

> Spinning off from Judge Hand's famous formula, if the magnitude of gain expected from a board decision, multiplied by the probability measured ex ante of achieving the gain, exceeds the magnitude of loss risked by the decision, multiplied by the probability of the loss, than the decision presumably is reasonable. Accordingly, a negligence standard should neither deter the taking of desirable risks nor punish simply bad results.[70]

If the aim is promoting reasonable risk taking, a simple negligence standard should suffice. Indeed, a more lenient standard creates a moral hazard, as directors can engage in high-risk ventures with shareholders' funds and without adequate risk of personal liability.

Moreover, legislators have created and/or permitted numerous alternative means of protecting directors from liability for their business decisions. For example, after the Delaware Supreme Court's

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67. *See, e.g.*, Mary Flood, *Opposing Enron Legal Teams on Parallel Paths: Defense Weighs Open-Ended Mandate and Scope of Task Force, Finds It Wanting*, HOUSTON CHRON., Dec. 19, 2004, at D1 (noting Enron's former chief executive officer, Jeff Skilling, and ex-Chairman, Ken Lay, were indicted on multiple fraud and conspiracy charges); Leon Lazaroff, *Ex-Tyco Chief, Top Lieutenant Found Guilty*, CHI. TRIB., June 18, 2005, at 1 (mentioning the conviction of Bernard J. Ebbers, former chairman of WorldCom Inc., on charges of engineering an $11 billion fraud); Phyllis Messinger et al., *10 Enron Players: Where They Landed After the Fall*, N.Y. TIMES, Jan. 29, 2006, § 3, at 8 (summarizing legal resolutions and post-Enron careers of ten leading figures in the Enron scandal).

68. Gevurtz, *supra* note 7, at 313.

69. As Chancellor Chandler recently put it:

> Should the Court apportion liability based on the ultimate outcome of decisions taken in good faith by faithful directors or officers, those decision-makers would necessarily take decisions that minimize risk, not maximize value. The entire advantage of the risk-taking, innovative, wealth-creating engine that is the Delaware corporation would cease to exist, with disastrous results for shareholders and society alike.

In re Walt Disney Co. Derivative Litig., 907 A.2d 693, 698 (Del. Ch. 2005), *aff'd*, 906 A.2d 27 (Del. 2006).

70. Gevurtz, *supra* note 7, at 305-06 (citing United States v. Carroll Towing Co., 159 F.2d 169 (2d Cir. 1947) (footnotes omitted)).

decision in *Smith v. Van Gorkom*,[71] Delaware amended its Corporations Law to permit corporations to stipulate in their bylaws that directors will not be liable for damages for breach of the duty of care.[72] According to the Delaware Supreme Court,

> [t]he purpose of [the amendment] was to permit shareholders—who are entitled to rely upon directors to discharge their fiduciary duties at all times—to adopt a provision in the certificate of incorporation to exculpate directors from any personal liability for the payment of monetary damages for breaches of their duty of care, but not for duty of loyalty violations, good faith violations and certain other conduct.[73]

Other states passed similar statutes,[74] most of which provide exculpation even in cases of gross negligence.[75] Some states have passed statutes permitting directors to consider the concerns of constituencies other than shareholders but not shielding directors from liability for breaches of the duty of care.[76]

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71. 488 A.2d 858 (Del. 1985).

72. DEL. CODE ANN. tit. 8, § 102(b)(7) (2001); *see, e.g.*, Emerald Partners v. Berlin, 787 A.2d 85, 90 (Del. 2001) (noting that section 102(b)(7) was passed following the *Van Gorkom* decision).

73. *Emerald Partners*, 787 A.2d at 90 (emphasis omitted); *see* Prod. Res. Group, L.L.C. v. NCT Group, Inc., 863 A.2d 772, 777 (Del. Ch. 2004) ("One of the primary purposes of § 102(b)(7) is to encourage directors to undertake risky, but potentially value-maximizing, business strategies, so long as they do so in good faith.").

74. Arkes & Schipani, *supra* note 53, at 617 ("Forty-six jurisdictions have enacted legislation which permits corporations to relieve directors from personal monetary liability to the corporation and its shareholders for breach of the fiduciary duty of care."); *see, e.g.*, CAL. CORP. CODE § 204(a)(10) (West 1990) (permitting provisions in a corporation's articles of incorporation eliminating or limiting the personal liability of a director for monetary damages in an action brought by or in the name of the corporation for breach of a director's duties to the corporation and its shareholders, except for acts or omissions in breach of the duty of loyalty, in bad faith, or constituting intentional misconduct); 805 ILL. COMP. STAT. ANN. 5/2.10(b)(3) (West 2004) (allowing for a provision in a corporation's articles of incorporation that eliminates or limits the personal liability of directors to the corporation or its shareholders for monetary damages for breach of fiduciary duty as a director except for any breach of the director's duty of loyalty, for acts or omissions not in good faith or that involve intentional misconduct or a knowing violation of law, or for participating in interested transactions); N.Y. BUS. CORP. LAW § 402(b) (McKinney 2003) (permitting certificates of incorporation to eliminate or limit personal liability for directors to the corporation or its shareholders for breaches of duty unless the breach is a product of bad faith, intentional misconduct, knowing violation of the law, or self-interested conduct).

75. Arkes & Schipani, *supra* note 53, at 617; *see, e.g.*, IND. CODE ANN. § 23-1-35-1(e)(2) (LexisNexis 1999) (stating that a director is not liable for any action taken as a director, or any failure to take action, unless "[t]he breach or failure to perform constitutes willful misconduct or recklessness"); VA. CODE ANN. § 13.1-692.1 (2006) (limiting directors liability for money damages except in cases of willful misconduct or knowing violations of law).

76. *See, e.g.*, MINN. STAT. ANN. § 302A.251(5) (West 2004) (permitting the corporation's board to consider other stakeholders); N.J. STAT. ANN. § 14A:6-1(2) (West 2003)

Similarly, Delaware law permits corporations to indemnify their officers and directors, as well as other employees and agents, against liability in civil or criminal actions.[77] Indemnification is mandatory under Delaware law where the officer or director incurs costs in connection with legal actions in which the officer or director "has been successful on the merits or otherwise."[78] Such indemnification is mandated even if the corporation pays to settle a suit that results from the officer's or director's bad faith misconduct.[79] Some states permit very broad indemnification, even if the result is that a corporation has to pay damages to itself on behalf of a director in the context of shareholder derivative litigation.[80] Finally, on top of protection from liability and indemnification, corporations may pay to insure their officers and directors against any liability that is beyond the scope of statutorily created powers of indemnification or protection from liability.[81] Such insurance can be quite broad and will be upheld as long as it is not contrary to public policy.[82]

(same); OHIO REV. CODE ANN. § 1701.59(E) (LexisNexis 2004) (same); 15 PA. CONS. STAT. ANN. § 1715(a)(1) (West 1995) (same).

77. DEL. CODE ANN. tit. 8, § 145(a)-(b).

78. *Id.* tit. 8, § 145(c).

79. *See* Waltuch v. Conticommodity Servs., Inc., 88 F.3d 87, 96-97 (2d Cir. 1996) (requiring indemnification under § 145(c) for litigation costs incurred by Waltuch in a suit that the company settled by paying $35 million to investors who alleged that Waltuch had engaged in fraud, market manipulation, and antitrust violations).

80. *See* N.Y. BUS. CORP. LAW § 722(c) (McKinney 2003). Section 722(c) provides:

> A corporation may indemnify any person made, or threatened to be made, a party to an action by or in the right of the corporation to procure a judgment in its favor by reason of the fact that he, his testator or intestate, is or was a director or officer of the corporation, or is or was serving at the request of the corporation as a director or officer of any other corporation . . . .

See also IND. CODE. ANN. § 23-1-37-8(a) ("A corporation may indemnify an individual made a party to a proceeding because the individual is or was a director against liability incurred in the proceeding . . . ."). "[A]uthorization of indemnification for 'liabilities incurred in a proceeding' is broader than the comparable GCA provision, which permitted indemnification for 'expenses' only." *Id.* § 23-1-37-8 cmt. a.

81. *See* DEL. CODE ANN. tit. 8, § 145(g).

82. *See* 2 BLOCK ET AL., *supra* note 15, at 1985-87 (noting that most directors and officers' insurance policies will not cover willful or felonious conduct and that at least one court has found that insurance against reckless conduct violates public policy); EASTERBROOK & FISCHEL, *supra* note 53, at 105 (defending insurance and indemnification schemes as allowing firms to contract around liability rules when markets are cheaper than courts and noting that these schemes are enforced "almost without exception"); Roberta Romano, *The Shareholder Suit: Litigation Without Foundation?*, 7 J.L. ECON. & ORG. 55, 57 (1991) ("Policies routinely exempt losses from adjudication of dishonesty, but if a claim is settled, courts prohibit insurers from seeking an adjudication of guilt and thereby avoiding the claim's payment. Similarly, while all policies exclude losses involving personal profit, if a suit

In addition, state legislatures have adopted procedural rules to deter suits against corporate directors.[83] The statutes, modeled on the *Revised Model Business Corporation Act*, require that a plaintiff post security for the corporation's expenses and attorneys' fees to be incurred in connection with the suit, unless the plaintiff is a significant shareholder (usually holding over 5% of outstanding shares or $25,000 worth of the defendant corporation's stock).[84] Such a security is not required either in Delaware or under the *Federal Rules of Civil Procedure*.[85] A number of explanations are offered for Delaware's refusal to pass such statutes: they discourage meritorious suits; they discriminate against minority shareholders; they are easily circumvented; and they are not necessary to protect corporations from meritless suits, especially as other means are available.[86] The fact that fourteen jurisdictions have nonetheless passed legislation granting corporations these additional protections suggests the lengths to which legislatures have gone to protect directors from potential liability.[87]

All of this legislation arose long after the Rule was already in place.[88] In short, if the Rule is intended to protect corporate decision

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alleging breach of both the duty of care and loyalty is settled, the insurer is required to cover the entire claim . . . .").

83. *See, e.g.*, Shiro Kawashima & Susumu Sakurai, *Shareholder Derivative Litigation in Japan: Law, Practice, and Suggested Reforms*, 33 STAN. J. INT'L L. 9, 44 (1997) (noting at least fourteen states allow corporations to require plaintiffs to post security for expenses in derivative suits); *see also* DEBORAH A. DEMOTT, SHAREHOLDER DERIVATIVE ACTIONS: LAW AND PRACTICE § 3.1 (2006) (stating sixteen states that require the posting of a bond).

84. *See* ARK. CODE ANN. § 4-26-714(c)(4) (2001) ("[T]he court shall fix the nature and amount of security to be furnished by the plaintiff for reasonable expenses, including attorneys' fees, which may be incurred by the moving party and the corporation in connection with such action, including, but without limiting, the foregoing expenses for which the corporation may become liable pursuant to § 4-26-814."); CAL. CORP. CODE § 800(c)(1)-(2)(d) (West 1990) (indicating that a corporation or defendant may seek a bond up to $50,000 in a shareholder derivative suit if (1) there is no reasonable possibility that the prosecution of the cause will benefit the corporation or its shareholders, or (2) the moving party, if not the corporation, did not participate in the complained of transaction); N.Y. BUS. CORP. LAW § 627 (McKinney 2003) (stating a corporation can require shareholders bringing a derivative suit to give security if their holdings are less than 5% of the outstanding shares and are valued at less than $50,000).

85. Kawashima & Sakurai, *supra* note 83, at 44.

86. *Id.* at 44-45. Kawashima and Sakurai suggest that sanctioning attorneys who bring meritless suits is a better means of deterring strike suits. *Id.* at 45 n.312. This seems unlikely, however, as moving for attorney sanctions merely adds a new layer of litigation to the corporation's burden.

87. *Id.* at 44.

88. *See* 1 BLOCK ET AL., *supra* note 15, at 9-11 (tracing the history of the Rule, noting its inception in England in 1742 and its development within American jurisprudence beginning in 1829); Gevurtz, *supra* note 7, at 287 ("[T]he rule, in one form or another, extends back through 160 years of judicial decisions.").

makers from the kind of exposure to liability that might make them risk averse, they seem to be more than adequately protected, even absent the Rule. If the Rule was once necessary to protect directors from liability for violations of their duty of care, statutory developments have rendered that aim obsolete.

3. The Sovereignty Rationale

In this Subpart, I will discuss two different versions of what Davis has termed the "sovereignty rationale" for the Rule.[89] The weaker, but more generally accepted, formulation of the sovereignty rationale acknowledges that corporations ought to be run in the interests of shareholders, but argues that because directors are elected by shareholders, the shareholders should hold them accountable through the mechanisms of corporate democracy rather than through litigation.[90] "Where stockholders are able to change the board because of inadequate performance, there is less reason for courts to intervene and police whether the directors are behaving reasonably."[91] This would be persuasive if the mechanisms for corporate accountability made corporate executives somewhat responsive to shareholder concerns. For the reasons given below, they do not, and thus the weak version of the sovereignty rationale is unconvincing.[92]

The stronger version of the sovereignty rationale is the doctrine of director primacy, which rejects the notion that shareholders have the right to control the corporations they own.[93] Countering both the

89. Davis, *supra* note 8, at 587 (citing DEL. CODE ANN. tit. 8, § 141(a) (directives that the corporation's affairs be managed by or under the direction of a board of directors)).

90. *See* 1 BLOCK ET AL., *supra* note 15, at 17 ("[T]he [Rule] ensures that directors rather than shareholders manage corporations."); Brown & Regner, *supra* note 6, at 2 ("Courts are mindful that shareholders have elected the directors, not the courts, to supervise the affairs of the corporations they own.").

91. Allen et al., *supra* note 23, at 456; *see In re* Walt Disney Co. Derivative Litig., 907 A.2d 693, 698 (Del. Ch. 2005), *aff'd*, 906 A.2d 27 (Del. 2006) ("The redress for failures that arise from faithful management must come from the markets, through the action of shareholders and the free flow of capital, and not from this Court."); Barnes v. Andrews, 298 F. 614, 618 (S.D.N.Y. 1924) ("Must a director guarantee that his judgment is good? Can shareholders call him to account for deficiencies which their votes assured him did not disqualify him for his office? While he may not have been the Cromwell for that Civil War, Andrews did not engage to play any such role.").

92. *See infra* Part II.B.3.a.

93. *See* Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547, 550-51 (2003) ("Shareholders do not own the corporation and, accordingly, directors are not stewards of shareholder wealth. Shareholders are simply a group of participants bound together by a web of voluntary agreements whose nexus the law treats as a firm."). Bainbridge notes, however, that though shareholders do not control corporations, they are the beneficiaries of the board's fiduciary duties under the

shareholder-primacy doctrine and managerialism,[94] the director-primacy doctrine contends that "[n]either shareholders nor managers control corporations—boards of directors do."[95] The director-primacy doctrine sides with shareholders as opposed to other "stakeholders" in the corporation as it "embraces the shareholder wealth maximization norm even as it rejects the theory of shareholder primacy."[96] However, the director-primacy doctrine rejects the notion that directors exercise powers over corporate matters only as agents of the shareholders.[97]

a. The Weak Sovereignty Rationale: Corporate Democracy

The only way to justify permitting directors to make business decisions with shareholders' capital is if the shareholders have agreed to place responsibility for such decisions in the hands of management. On first glance, it seems obvious that they have done so, either based on a theory of corporate democracy or based on simple contract law. Either shareholders have consented to the delegation of decision-making authority to the board through elections of the board's members or, by purchasing shares in a corporation, they have

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director-primacy doctrine. *Id.* at 550; *see* Michael P. Dooley, *Two Models of Corporate Governance*, 47 BUS. LAW. 461, 462-63 (1992) (criticizing the ALI Governance Project for adopting a "responsibility model" rather than the "authority model" of corporate governance which Dooley believes to be "the prevailing judicial and statutory precedent").

94. Managerialism has its origins in the classic work of ADOLF A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 217 (4th rev. ed. 1968). For a concise review of the managerialist approach, see Alfred F. Conard, *Beyond Managerialism: Investor Capitalism?*, 22 U. MICH. J.L. REFORM 117, 120-30 (1988). Bebchuk and Fried concisely summarize the central doctrines of the managerialist school as follows:

> The dispersed owners of a typical publicly traded company cannot monitor or direct managers' actions, so the executives who exert day-to-day control in such companies often have considerable discretion. In such a situation, ownership and control are separated. Shareholders own the company, but the managers exercise a substantial amount of control over how it is run.

BEBCHUK & FRIED, *supra* note 47, at 15. In the managerialist account, shareholders are dispersed and hold diversified portfolios; accordingly, they are relatively apathetic with respect to the management of the corporations they own. This apathy permits managers and inside directors to exercise effective control over the corporation. Lynne L. Dallas, *The New Managerialism and Diversity on Corporate Boards of Directors*, 76 TUL. L. REV. 1363, 1370-71 (2002).

95. Bainbridge, *supra* note 93, at 550.

96. *Id.* at 551.

97. *Id.* at 548 n.8 (citing with disapproval Chancellor Allen's view in *Blasius Industries, Inc. v. Atlas Corp.*, 564 A.2d 651, 663 (Del. Ch. 1988), that "[t]he theory of our corporation law confers power upon directors as the agents of the shareholders; it does not create Platonic masters").

presumably consented to the corporate governing structure, which delegates decision-making authority to the board.[98]

Three considerations might make us question whether theories of corporate democracy and freedom of contract really justify the protections afforded to corporate decision makers under the Rule. First, it is usually the case that common shareholders have no real voice in choosing the people who make decisions on behalf of a public corporation.[99] Outside of the context of hostile takeovers, electoral challenges to incumbent board members are "practically nonexistent," averaging about two per year between 1996 and 2002 in corporations with market capitalization in excess of $200 million.[100]

Second, even if we were convinced that common shareholders had actual power to elect boards, boards and executives deprive shareholders of information to which they are entitled and which they could use to protect their interests as shareholders.[101] At times, it is perfectly appropriate for a board to make decisions without informing shareholders. Much of what boards do is confidential and could not be openly discussed without doing irreparable harm to the corporation (and thus to shareholders) by disclosing prospective business plans and strategy.[102] However, as we shall see in the context of executive

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98. *See In re* Walt Disney Co. Derivative Litig., 907 A.2d 693, 746 (Del. Ch. 2005), *aff'd*, 906 A.2d 27 (Del. 2006) ("The [Rule] serves to protect and promote the role of the board as the ultimate manager of the corporation.").

99. Lucian Arye Bebchuk, *The Case for Shareholder Access to the Ballot*, 59 BUS. LAW. 43, 45 (2003) ("Although shareholder power to replace directors is supposed to be an important element of our corporate governance system, it is largely a myth.").

100. BEBCHUK & FRIED, *supra* note 47, at 25; Bebchuk, *supra* note 99, at 46.

101. *See* discussion *infra* notes 216-219 and accompanying text regarding camouflage of executive compensation.

102. *See* Tender Offers, Securities Act Release No. 6158, Exchange Act Release No. 16,384, Investment Company Act Release No. 10,958, 44 Fed. Reg. 70,326, 70,335-36 (Nov. 29, 1979) (considering secrecy in the context of a Schedule 14D-9 filing and illustrating the SEC's attempts to accommodate business demands for secrecy); *see also* Schedule 14D-9, 17 C.F.R. 240.14d-101 (2006); 17 C.F.R. 229.1006 Instruction to Item 1006(d)(1) (2006) ("If an agreement in principle has not been reached at the time of filing, no disclosure . . . is required of the possible terms of or the parties to the transaction if in the opinion of the board of directors of the subject company disclosure would jeopardize continuation of the negotiations."); Hockett v. Sun Co., 109 F.3d 1515, 1523 (10th Cir. 1997) (finding in the context of ERISA that requiring employers reveal their internal deliberations could hinder the achievement of "'business goals' by allowing competitors to know that the employer is considering a labor reduction, . . . a merger, or some other strategic move"); Staffin v. Greenberg, 672 F.2d 1196, 1206 (3d Cir. 1982) (finding merit in the opinions of other courts and commentators that in the area of takeover bids, disclosure of such discussions may do more harm to the corporation than secrecy itself); Jonathan R. Macey & Geoffrey P. Miller, *Good Finance, Bad Economics: An Analysis of the Fraud-on-the-Market Theory*, 42 STAN. L. REV. 1059, 1091 (1990) (arguing corporate information should not be disclosed if, in the directors' judgment, the disclosure would jeopardize the value of the firm's shares in the

compensation schemes, boards also deprive shareholders of information to which they are entitled when disclosure of the information poses no risk of harm to the interests of the corporation other than the reputational or outrage harm that would attach to disclosure of excessive executive compensation. Where there is no need to protect the confidentiality of decision-making processes, there is no reason why directors should not answer to the shareholders in whose interests they are supposed to act.

Finally, even if we believe that shareholders freely elect corporate directors, those directors have fiduciary duties to protect the interests of both the corporation and the shareholders.[103] Thus, it hardly seems appropriate to shield the fiduciaries from liability for negligent conduct in connection with the execution of their fiduciary duties when we do not similarly shield other professionals in whom individuals place their trust and confidence.[104]

Even if we view the relationship between shareholders and directors as a voluntary one in which shareholders have delegated certain decision-making powers to the directors, it is not clear why the directors should not be held to an ordinary negligence standard. The decision to invest in a corporation can be analogized to the process of choosing to enter into a relationship with a provider of professional services, such as a doctor, a lawyer, an architect, or a mechanic.[105] The fact that one enters the relationship deliberately does not protect the professional from liability if she performs her professional tasks negligently.[106]

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aggregate); Dale Arthur Oesterle, *The Inexorable March Toward a Continuous Disclosure Requirement for Publicly Traded Corporations: "Are We There Yet?,"* 20 CARDOZO L. REV. 135, 136 & n.1 (1998) (stating that managers are willing to disclose large amounts of information to appease investors, but managers prefer not to disclose "[s]ome information [that] is too valuable to reveal to one's competitors" because "[i]nformation about strategy and business segments can help competitors if too much detail is offered, hurting shareholders in the process").

103. *See* Malone v. Brincat, 722 A.2d 5, 10 (Del. 1998) ("The shareholder constituents of a Delaware corporation are entitled to rely upon their elected directors to discharge their fiduciary duties at all times."); Kaplan v. Peat, Marwick, Mitchell & Co., 540 A.2d 726, 729 (Del. 1988) ("The exercise of this managerial power is tempered by fundamental fiduciary obligations owed by the directors to the corporation and its shareholders."); Guth v. Loft, Inc., 5 A.2d 503, 510 (Del. 1939) ("[Directors] stand in a fiduciary relation to the corporation and its stockholders.").

104. *See* Gevurtz, *supra* note 7, at 315.

105. *Id.*

106. *See id.* ("The fact that shareholders have entered into a voluntary relationship with the directors is not different from most situations involving malpractice claims. The same is generally true of patients with doctors, clients with attorneys, and a host of other situations out of which negligence actions may arise.").

Easterbrook and Fischel offer what might be considered a corollary to this weak sovereignty approach, placing their faith in the efficiency of capital markets.[107] Shareholders who are dissatisfied with the stewardship of a corporation will simply take their money elsewhere, and they are also able to diversify their risk by investing in numerous firms across capital markets.[108] This model suggests that corporations served by poor managers will underperform. Investors, if they are paying attention, will move on, and the managers will be replaced with better ones when the corporation's fortunes suffer accordingly. But markets do not always work this way, and, even if they did, this rationale does little to explain why the Rule should prevent an investor who was harmed by a board's negligence from seeking legal redress for that wrong. When investors discover the breach, they may well choose to move their capital elsewhere but by the time they do so, they already may have suffered significant losses.

b. The Strong Sovereignty Rationale: Director Primacy

The director-primacy model is a significant conceptual contribution to our understanding of the way corporations both do and should operate. Director primacy provides the most sophisticated account of why the Rule is necessary to protect directors from liability for their business decisions. For that reason, it is worthwhile to explore the theory of director primacy in some detail. This Article concludes that though the theory that directors, not shareholders, are the center of decision-making power within the corporation is generally correct, there are still circumstances in which the board must answer to the corporation's shareholders. In such circumstances, the Rule should not impede the realization of the goal of shareholder wealth maximization.

As a descriptive model, director primacy has certain advantages over the dominant shareholder-primacy model.[109] As a normative model, directory primacy has certain advantages over managerial approaches to the corporation.[110] If we adopt the director-primacy model, we would expect to favor a robust Rule that safeguards the

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107. *See* EASTERBROOK & FISCHEL, supra note 53, at 96 ("Managers must perform well to keep share prices high; if they do not, they can expect to be replaced.").

108. *Id.* at 99; *see In re* Walt Disney Co. Derivative Litig., 907 A.2d 693, 698 (Del. Ch. 2005), *aff'd*, 906 A.2d 27 (Del. 2006) ("The redress for failures that arise from faithful management must come from the markets, through the action of shareholders and the free flow of capital, and not from this Court.").

109. *See infra* notes 113-128 and accompanying text.

110. *See infra* notes 129-145 and accompanying text.

authority of boards to make the decisions that corporate structures have placed in their hands.[111]

The argument for director primacy derives from a contractarian view of the corporation that attempts to avoid reification of the corporation by viewing it as a nexus of contracts.[112] According to the director-primacy model, there must be some decision-making power that permits action by a nonreified corporation,[113] and the center of that action is the board of directors.[114] "The board of directors thus can be seen as a sort of Platonic guardian—a *sui generis* body serving as the nexus for the various contracts making up the corporation and whose powers flow not from shareholders alone, but from the complete set of contracts constituting the firm."[115] This view of the corporation seems to find some statutory support in section 141(a) of Delaware's General Corporation Law and the *Van Gorkom* decision:

> "Under Delaware law, the [Rule] is the offspring of the fundamental principle, codified in [Delaware General Corporation Law] § 141(a), that the business and affairs of a Delaware corporation are managed by or under its board of directors.... The [Rule] exists to protect and promote the full and free exercise of the managerial power granted to Delaware directors."[116]

Shareholders, by contrast, "have no power to initiate corporate action," as the statutory structure "is one in which the board acts and the shareholders, at most, react."[117] In addition, in response to arguments that executives, not directors, control corporations, the director-

111. *See* Bainbridge, *supra* note 93, at 603 ("The [Rule] prevents such a shift in the locus of decisionmaking authority from boards to judges by establishing a limited system for case-by-case judicial oversight in which review of the substantive merits of those decisions is avoided.").

112. *Id.* at 552-53; *see* Stephen M. Bainbridge, Book Review Essay, *Executive Compensation: Who Decides?*, 83 TEX. L. REV. 1615, 1646 (2005) (reviewing BEBCHUK & FRIED, *supra* note 47) ("[S]hareholders have no natural or inherent rights of ownership or control. Instead, they have only those rights for which they bargained. And those rights are extremely limited." (footnote omitted)).

113. Bainbridge, *supra* note 93, at 555. I do not share the contractarians' concerns regarding reification. Once we recognize that certain business associations are to be treated as legal persons, we transform such entities into subjects for both legal and real-world purposes. The reification has occurred, and I see no advantage in a legal theory that pretends otherwise.

114. *Id.* at 559.

115. *Id.* at 560.

116. Bainbridge, *supra* note 6, at 109 (quoting Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985)); *see In re* Walt Disney Co. Derivative Litig., 907 A.2d 693, 746 (Del. Ch. 2005), *aff'd*, 906 A.2d 27 (Del. 2006) ("The [Rule] serves to protect and promote the role of the board as the ultimate manager of the corporation.").

117. Bainbridge, *supra* note 93, at 559.

primacy model contends that "[i]n situations of overt conflict between the board and top management, the board's authority prevails as a matter of law, if not always in practice."[118]

This quotation provides two key openings for criticism of the director-primacy approach. First, as we shall discuss in further detail in the context of executive compensation, situations of conflict between boards of directors and top management are exceedingly rare—not because managers are beholden to the board, but because managers dominate the board.[119] Second, in rare cases of conflict between a board and managers, while the board's authority should always prevail as a matter of *law*, if it does prevail as a matter of *fact*, it does so only in response to shareholder derivative suits or other outside pressures that call attention to breaches of duties owed by executives.[120]

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118. *Id.* at 563.

119. *See* discussion *infra* Part III.B.3. There is extensive literature on the phenomenon known as "board capture." *See, e.g.*, Charles M. Elson, *Director Compensation and the Management-Captured Board—The History of a Symptom and a Cure*, 50 SMU L. REV. 127, 134 (1996) (suggesting that equity compensation of board members will transform them into owner-directors and reduce the possibility of board passivity); Charles M. Elson, *The Duty of Care, Compensation, and Stock Ownership*, 63 U. CIN. L. REV. 649, 709 (1995) ("The most critical problem confronting United States corporation law today is . . . the flourishing of the passive board created by management capture.").

120. Some recent examples: Radio Shack's CEO, David Edmondson, resigned in a "mutual decision" with the board after revelations that he had fabricated credentials on his résumé. Floyd Norris, *RadioShack Chief Resigns After Lying*, N.Y. TIMES, Feb. 21, 2006, at C1 [hereinafter Norris, *RadioShack Chief Resigns*]. RadioShack agreed to pay the departing executive a severance package of $975,000. Floyd Norris, *Former RadioShack Chief May Gain from Options*, N.Y. TIMES, Feb. 22, 2006, at C3 [hereinafter Norris, *Former RadioShack Chief May Gain From Options*]. Clearly all the negative publicity relating to this revelation was crucial, because the board was not moved to act by the fact that "RadioShack's stock performed poorly in the time after Mr. Edmondson became president," although the move might have been motivated by the twelve percent decline in the stock during the week when Mr. Edmondson's fabricated credentials were disclosed. Norris, *RadioShack Chief Resigns*, at C1. Analog Devices recently disclosed that it paid its CEO, Jerald Fishman, $144.7 million in deferred compensation. Gretchen Morgenson, *A 'Holy Cow' Moment in Payland*, N.Y. TIMES, Feb. 19, 2006, § 3, at 1. Although such disclosures would be required under new proposed SEC rules, a company spokeswoman explained that Analog Devises "wanted to be completely transparent to its shareholders." *Id.* A commendable sentiment but apparently not consistent with the company's past practices; it is in the midst of settling with the SEC to end the investigation into allegations the company improperly timed its options' grants to officers and directors so the options would be granted just prior to the release of favorable financial reports. *Id.* Analog Devises is reported to have agreed to pay a $3 million penalty, while Mr. Fishman will pay $1 million plus a disgorgement penalty of undisclosed magnitude. *Id.* The company neither admits nor denies any wrongdoing. *Id.* Apparently, the company's desire to be "completely transparent to its shareholders" has its limits. *Id.*; *see* Rakesh Khurana & Katharina Pick, *The Social Nature of Boards*, 70 BROOK. L. REV. 1259, 1273 (2005) ("A popular criticism leveled by legislators and scholars against boards involved in recent corporate scandals is that they did not have the courage or the conviction to challenge senior management and/or the CEO on important issues.").

The theory of director primacy purports to be both normatively and descriptively more accurate than the shareholder-primacy model.[121] The model is descriptively superior, Bainbridge contends, because most of the time boards make decisions that are not subject to shareholder review: "In general, shareholders of public corporations have neither the legal right, the practical ability, nor the desire to exercise the kind of control necessary for meaningful monitoring of the corporation's agents."[122] The model is normatively superior because director primacy permits the corporation to achieve its most important goal: shareholder wealth maximization.[123]

As a normative matter, given all the clear conflicts of interest brought to light by recent corporate governance scandals,[124] Bainbridge's claim that boards can protect shareholder interests and uphold the norm of shareholder wealth maximization is undercut by his concession that "a substantial number of directors feel a responsibility towards stakeholders" and thus will not always decide in favor of shareholder wealth maximization.[125] One area that scholars have identified where the interests of shareholders and the interests of directors diverge is in long-term versus short-term rises in stock prices.[126] The real conflict of interest here is actually between

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121. Bainbridge, *supra* note 93, at 563-74; *see* Bainbridge, *supra* note 6, at 86 ("I have argued elsewhere that shareholder primacy is neither normatively persuasive nor descriptively accurate."). *But see* Wayne O. Hanewicz, *Director Primacy,* Omnicare, *and the Function of Corporate Law*, 71 TENN. L. REV. 511, 514-15 (2004) (identifying both descriptive and normative weakness in the director-primacy model).

122. Bainbridge, *supra* note 93, at 568.

123. *Id.* at 551-52.

124. *See* Rachel Beck, *Corporate Takeovers Can Bring Executives Big Takeaways*, ST. LOUIS POST-DISPATCH, June 5, 2005, at E7 ("'Executives keep finding way[s] to reward themselves, even when shareholders or their workers might not be getting the best deal . . . .'"); Claudia H. Deutsch, *Take Your Best Shot: New Surveys Show that Big Business Has a P.R. Problem*, N.Y. TIMES, Dec. 9, 2005, at C1 ("Pollsters, researchers, even many corporate chiefs themselves say that business is under attack by a majority of the public, which believes that executives are bent on destroying the environment, cooking the books and lining their own pockets."); Kurt Eichenwald, *Big Test Looms for Prosecutors at Enron Trial*, N.Y. TIMES, Jan. 26, 2006, at A1 ("Enron has emerged as a company that failed to follow the dictates of federal securities laws, with executives who deceived investors, directors and, in some cases, one another."); Arthur Levitt Jr., *Cutting the Corruption*, WASH. POST, Jan. 23, 2006, at A15 ("As with many of the disgraced corporations of the past few years—Adelphia, Tyco and WorldCom, for example—. . . [c]onflicts of interest abound, oversight has been myopic and those given the public's trust have used it to enrich themselves.").

125. Bainbridge, *supra* note 93, at 576.

126. Lucian A. Bebchuk & Jesse M. Fried, *Executive Compensation at Fannie Mae: A Case Study of Perverse Incentives, Nonperformance Pay, and Camouflage*, 30 J. CORP. L. 807, 808 (2005) ("[T]he structure of both equity and non-equity compensation provides executives with incentives to inflate short-term earnings at the expense of long-term shareholder value.").

managers, whose incentive-based compensation often depends on hitting certain performance targets, and shareholders, who may value more highly a slow, steady accumulation of value in the corporation.[127] However, in this conflict between shareholder interests and managerial interests, boards consistently side with management, in part because their own incentives are linked to short-term performance.[128]

Director-primacy theorists are certainly correct to point out that, from the perspective of a normative theory of corporate governance, director primacy is preferable to managerialism because managers are less likely than directors to make shareholder wealth maximization their prime objective.[129] However, because director-primacy theory concedes that the purpose of the corporation is the maximization of shareholder wealth, shareholder primacy holds the normative edge over director primacy, even if directors do a fairly good job of looking out for shareholder interests. While rational-choice models seem to indicate that boards are well-equipped to promote shareholder interests,[130] those models do not show that boards are better-equipped to do so than are the shareholders themselves. Thus, although the director-primacy model has a strong advantage over managerialism on the normative side, it cannot provide a general, normative model of how corporations should be run in the interests of shareholder wealth maximization because there are a small but significant number of circumstances where shareholder and board interests are not aligned. In such circumstances, the Rule creates an impediment to shareholders seeking to force boards to maximize value for shareholders. Such an impediment is only proper where shareholder litigation threatens vital interests of the corporation.

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127. *Id.* at 809-12 (detailing how executive pay at Fannie Mae created "perverse incentives" to inflate annual earnings but provided no penalties when the company later had to restate its earnings); Dallas, *supra* note 94, at 1365 ("[T]he new managerialism involves greater attention to short-term shareholder value, which also does not serve the interests of shareholders.").

128. *See* BEBCHUK & FRIED, *supra* note 47, at 205 (noting companies now routinely compensate directors with equity, including option grants). One recent study shows a correlation between executive pay and director pay, suggesting that directors will go along with managers in order to be rewarded more generously for their services to the company. Ivan E. Brick et al., *CEO Compensation, Director Compensation, and Firm Performance: Evidence of Cronyism?*, 12 J. CORP. FIN. 403, 421 (2006).

129. *See* Bainbridge, *supra* note 93, at 561 ("In the famous debate between [managerialists] Adolf Berle and E. Merrick Dodd, . . . both theorists assumed the existence of managerial discretion distinct from powers delegated by the board of directors or from duties to shareholders.").

130. *See id.* at 574-92 (contending directors have substantial incentives to run their corporations in the interests of the corporation's shareholders).

While director primacy has the normative edge over managerialism, managerialism seems to have a far stronger empirical basis than the director-primacy model, and thus the director-primacy model is more vulnerable to criticism on the descriptive level than it is on the normative level. Directors do not run corporations; for the most part, they simply approve decisions made by executives.[131] Although those executives are, in theory, chosen by and accountable to the board, in reality, boards are generally dominated by corporate executives who do not have the time, the interest, the expertise, or the incentive to act as significant checks on managerial decision-making authority.[132]

Decades ago, Melvin Eisenberg recognized that boards of directors had become largely passive.[133] Indeed, Eisenberg concluded:

> Many of the modern board's functions . . . are for the most part relatively unimportant, or can easily be located elsewhere. Making business policy, although widely held to be a central board function, is usually beyond the competence of the board, since a corporate organ cannot be meaningfully involved in making business policy unless its members are highly active, and it is not realistic to expect a high degree of activity from the board.[134]

Today, corporate boards' one significant remaining responsibility is the selection and monitoring of the corporation's CEO.[135] However, passivity characterizes the board's typical role in that process as well.[136] The protections provided by the Rule, if applied in the context of

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131. *See* MELVIN A. EISENBERG, THE STRUCTURE OF THE CORPORATION: A LEGAL ANALYSIS 140 (1976) ("[A]ll serious students of corporate affairs recognize that . . . in the typical large publicly held corporation the board does not 'manage' the corporation's business in the ordinary meaning of that term. Rather, that function is vested in the executives.").

132. *In re* Walt Disney Co. Derivative Litig., 907 A.2d 693, 761 n.490 (Del. Ch. 2005), *aff'd*, 906 A.2d 27 (Del. 2006) ("[T]he law recognizes that corporate boards . . . cannot themselves manage the operations of the firm, but may satisfy their obligations by thoughtfully appointing officers, establishing or approving goals and plans and monitoring performance.").

133. *See* EISENBERG, *supra* note 131, at 140 (citing research indicating that boards of large corporations did not initiate decisions on either specific or broad matters and were largely passively approving policies initiated by management).

134. *Id.* at 169.

135. *See id.* at 162 (describing the board's role in electing and dismissing CEOs as "both of critical importance to the corporation and uniquely suited for performance by the board").

136. *See* EISENBERG, *supra* note 131, at 164 (characterizing the board's role in selecting a CEO as "real albeit restrained"); RAKESH KHURANA, SEARCHING FOR A CORPORATE SAVIOR: THE IRRATIONAL QUEST FOR CHARISMATIC CEOS, at x (2002) (arguing that boards tend to select CEOs "for their social attributes rather than for their possession of relevant skills and experience").

executive compensation, are a significant impediment to boards' performance of their most important remaining duty.

Bainbridge notes that "modern boards of directors . . . meet more often, are more independent from management, own more stock, and have better access to information" than their predecessors.[137] Bainbridge therefore contends that "board-capture" by management "seems less valid today . . . than it once was."[138] However, there simply is not adequate evidence that recent reforms have had any effect on director performance.[139] Rather, as recent corporate scandals establish, boards still too often merely rubber stamp the decisions of corporate officers.[140]

Though the reforms that Bainbridge mentions are significant, it is hard to imagine how boards are now better able to control a corporation than they were previously, when outside directors still devote very little time to their directorial duties. Research suggests that the average outside director devotes 100 hours per year to his or her duties as director.[141] The numbers were not much different a generation ago.[142] Based on the amount of time outside directors devoted to their duties as board members in the 1980s, Bayless Manning concluded that no human being could stay on top of all of the aspects of a corporation's business "on a one-and-a-half-day-a-month basis."[143] Manning also noted that management, not outside directors, sets the agenda for board meetings.[144] Boards thus largely rely on

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137. Bainbridge, *supra* note 93, at 563.

138. *Id.* at 562.

139. *See* KHURANA, *supra* note 136, at 81-82 (summarizing recent quantitative studies that indicate director shareholding has little effect on director behavior or firm performance). Bainbridge's assertions to the contrary seem overly optimistic. *See* Bainbridge, *supra* note 93, at 562-63 (citing trends in the 1980s and 1990s that "encourage more active and effective board oversight").

140. *See* Susan-Jacqueline Butler, *Models of Modern Corporations: A Comparative Analysis of German and U.S. Corporate Structures*, 17 ARIZ. J. INT'L & COMP. LAW 555, 588 (2000) (stating that some boards rubber stamp anything that a corporate officer proposes); Eric A. Lustig, *IRS, Inc.—The IRS Oversight Board—Effective Reform or Just Politics? Some Early Thoughts from a Corporate Law Perspective*, 42 DUQ. L. REV. 725, 755 (2004) ("Commentators have long challenged whether the corporate board of directors actually governs corporations, or whether it is largely a rubber stamp for the chief executive officer, who is often the chairman of the board.").

141. BEBCHUK & FRIED, *supra* note 47, at 37.

142. Manning, *supra* note 24, at 1481 ("The most recent survey (1982) shows that the average director of a publicly held company devotes a total of about 123 hours per year to his board and committee work, including travel.").

143. *Id.*

144. *Id.* at 1484.

management to run things and intervene only in exceptional circumstances.[145]

The fundamental insight of director primacy derives from Kenneth Arrow's view that decision-making structures must be based either on consensus or authority.[146] Given these options, in large-scale business organizations, authority-based models have clear efficiency advantages over consensus-based models for decision making: "[T]he chief economic virtue of the public corporation is not that it permits the aggregation of large capital pools, but rather that it provides a hierarchical decisionmaking structure well-suited to the problem of operating a large business enterprise with numerous employees, managers, shareholders, creditors, and other inputs."[147] Following Arrow, the adherents of the director-primacy theory regard the balance between authority and accountability as a zero-sum game: the more boards are held accountable to shareholders, the less the corporation derives efficiency benefits from its hierarchical structure.[148] From this perspective, the organizational advantage of the corporation is lost if the board's decision-making authority is subject to constant review by the consensus-based shareholders—"If every decision of *A* is to be reviewed by *B*, then all we have really is a shift in the locus of authority from *A* to *B*."[149]

Bainbridge returns to this mantra at every opportunity,[150] and yet he also acknowledges that "[t]he right to fire is not the right to exercise fiat; it is only the right to discipline."[151] Indeed, it is no more

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145. *See id.* at 1484-85 (describing two exceptional circumstances when boards seize the initiative).

146. KENNETH J. ARROW, THE LIMITS OF ORGANIZATION 68-70 (1974).

147. Bainbridge, *supra* note 93, at 572.

148. *See* Bainbridge, *supra* note 112, at 1654 (arguing against increasing shareholder power over review of board decisions "because it defeats the very purpose of authority-based decisionmaking structures—namely, to concentrate discretionary authority in the hands of a central agency with power to make decisions that are binding on the whole").

149. ARROW, *supra* note 146, at 78 (emphasis added). A similar formula has been adopted by the former Chief Justice of the Delaware Supreme Court:

> The power to hold to account is the power to interfere and, ultimately, the power to decide. If stockholders are given too easy access to courts, the effect is to transfer decisionmaking power from the board to the stockholders .... By limiting judicial review of board decisions, the [Rule] preserves the statutory scheme of centralizing authority in the board of directors.

Michael P. Dooley & E. Norman Veasey, *The Role of the Board in Derivative Litigation: Delaware Law and the Current ALI Proposals Compared*, 44 BUS. LAW. 503, 522 (1989).

150. *See, e.g.*, Bainbridge, *supra* note 6, at 108; Bainbridge, *supra* note 93, at 573, 603; Bainbridge, *supra* note 112, at 1650, 1654.

151. Bainbridge, *supra* note 93, at 570.

problematic from the perspective of the efficiency of decision-making processes to recognize ultimate shareholder primacy than it is to recognize that the U.S. government is ultimately answerable to the people. If every decision by a board were subject to the grueling process of shareholder review, corporate decision-making processes would grind to a halt, just as the U.S. government could not function if every executive or legislative decision were subject to approval by plebiscite. Nonetheless, the U.S. government must, in the end, answer to the people, and corporate boards must answer to their shareholders. Moreover, as the advocates of director primacy acknowledge, because the mechanisms of shareholder oversight are cumbersome and expensive, there is little danger that shareholder primacy would throw a wrench into the mechanisms of corporate decision making, even if directors are not protected by the Rule.[152] Even if the reality of corporate governance is that shareholders rarely yield actual control, the weakness of the director-primacy model is that it "overlooks the important (albeit limited) situations in which corporate legal rules do and should vest decision-making authority elsewhere."[153] As the adherents of director primacy acknowledge, shareholder primacy remains the dominant view among corporate law scholars.[154]

But that does not mean that most legal scholars view shareholders as controlling the day-to-day operations of the corporation. Rather, shareholders, often acting through courts, only occasionally take authority from the board in order to protect what most agree is the primary goal of the corporation, shareholder wealth maximization.[155]

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152. *Id.* at 557-58. Bainbridge identifies collective action problems, as well as "rational apathy," as sources of shareholder inaction. *Id.* But there are also numerous and significant procedural hurdles that shareholders must overcome before they can challenge board decisions, including the requirement that plaintiffs either make "demand" on the board to investigate the cause of action or claim that demand is excused as futile. Roberta Romano summarizes the issue very succinctly: "The efficacy of shareholder litigation as a governance mechanism is hampered by collective action problems because the cost of bringing a lawsuit, while less than shareholders' aggregate gain, is typically greater than a shareholder-plaintiff's pro rata benefit." Romano, *supra* note 82, at 55; *see* Aronson v. Lewis, 473 A.2d 805, 811-12 (Del. 1984) ("[T]he demand requirement of Chancery Rule 23.1 exists at the threshold, first to insure that a stockholder exhausts his intracorporate remedies, and then to provide a safeguard against strike suits.").

153. Hanewicz, *supra* note 121, at 520.

154. *See* Bainbridge, *supra* note 93, at 563 ("Today, most corporate law scholars embrace some variant of shareholder primacy."); Bainbridge, *supra* note 6, at 85 ("In the academic literature, the prevailing answers to these questions [relating to the purposes and control of corporations] are provided by the shareholder primacy model.").

155. *See* Hanewicz, *supra* note 121, at 515 ("[D]irector primacy overlooks the infrequent, but nonetheless important, times when decision-making authority is taken from the board and vested in other institutions, such as the courts or the shareholders.").

While the director-primacy approach has obvious advantages over the shareholder-primacy model in describing the day-to-day workings of corporations in which ordinary shareholders have little say, both *de facto* and *de jure*, our system of corporate law recognizes that ultimate control lies in the hands of shareholders.[156]

Director-primacy theorists contend that the major benefits of corporate governing structures are lost if the authority of directors is subordinated to that of shareholders.[157] In fact, however, numerous factors, both practical and statutory, prevent shareholders from interfering in day-to-day decision-making processes involving corporate boards and executives. Nonetheless, in cases of conflict between the shareholders' interests and those of the board, shareholders must retain the ultimate authority to hold directors accountable, and the Rule should not impede existing mechanisms of director accountability to shareholders.

C. *Preliminary Conclusion*

The foregoing discussion permits some tentative conclusions. It is clear that despite its widespread use by courts to excuse directors from liability for violations of their duty of care, the Rule is a poorly understood piece of legal doctrine. Most courts view the Rule as either an evidentiary presumption or a heightened standard of liability rather than as an abstention doctrine, and as such, it serves mostly to protect individual directors, not corporations, from the risks and costs of litigation. The interests of the corporation are protected only indirectly—to the extent it is in the interest of the corporation to be able, through the Rule, to shield its directors from liability. Indeed, most justifications for the Rule focus on the need to protect directors—because we believe them more qualified than judges to make business decisions, or because we want to encourage risk taking by business leaders, or because we think the structure of corporate governance entitles them to be checked only through the most deferential forms of review. None of these justifications for the Rule is satisfactory. Moreover, as a standard of review rather than an abstention doctrine, the Rule does relatively little to protect

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156. *See* Malone v. Brincat, 722 A.2d 5, 9 (Del. 1998) (discussing the board's fiduciary duties owed to the company's shareholder owners).

157. *See, e.g.*, Bainbridge, *supra* note 93, at 557 ("It is very hard (if not impossible) to imagine a modern public corporation that could be effectively run using consensus-based decisionmaking mechanisms.").

corporations from the harms attendant to litigation, especially the discovery process.

The tendency of courts to view the Rule as requiring a heightened standard of review rather than as an abstention doctrine is curious because abstention makes more sense based on the standard justifications for the Rule. If the Rule exists because business leaders are better positioned to make business decisions than judges, changing the standard of review is clearly an inadequate solution. If a judge is not well-qualified to determine whether a director's judgment was negligent, she is also not well-qualified to determine whether that judgment crossed the line from ordinary into gross negligence or some other such standard. Rather, if our concern is with competence, judges should simply refrain from any substantive review of business decisions taken by a non-self-interested board after due consideration and absent evidence of fraud or bad faith.

Similarly, if the purpose of the Rule is to encourage risk taking by corporate decision makers, treating the Rule as a heightened standard of review is not nearly as effective as treating the Rule as an abstention doctrine. However, because statutory protections already shield board members from personal liability in most cases involving alleged breaches of the duty of care, the real purpose of the Rule today should not be to protect board members from liability but to protect the corporation and the board from the dissipation of assets and reputational harm that results from litigation. But a heightened standard of review does little to discourage litigation challenging board decisions, and, if courts do not treat the Rule as an abstention doctrine, they subject directors to the humiliation associated with a substantive review of their decision-making process, which in turn could deter boards from engaging in the risky business ventures that the Rule is designed to encourage. Only a rule of abstention that prevents any review of the substance of board decisions really insulates both boards and corporations from exposure to harmful litigation.

Finally, if one subscribes to the sovereignty rationale behind the Rule, heightened scrutiny makes very little sense. If one believes that through the structures of corporate governance or through the nexus of contracts that create corporations, shareholders have delegated to corporate boards the authority to make decisions on behalf of the corporation, it should follow that courts should respect that contractual allocation of authority and abstain from review of board decisions rather than review such decisions under a deferential standard.

Insofar as it embraces the abstention approach to the Rule, this Article advocates strengthening the Rule as a prophylactic tool that protects corporations from exposure to litigation. In its current incarnation, the Rule does little to protect the corporation's interests. Indeed, the dynamics of shareholder derivative suits leads to settlements that benefit plaintiffs' attorneys[158] but not really the corporation or its shareholders, who end up paying for the suit through higher insurance costs the corporation is forced to pay.[159]

However, the Rule's deployment should be limited to those circumstances when the prospect of litigation genuinely threatens the well being of the corporation. Otherwise, the Rule prevents shareholder derivative suits from serving their purpose as a check on management.[160] The Rule should apply only to cases in which the discovery attendant to litigation would require corporations to disclose prospective business plans. Such cases could arise in many contexts. After a quick review of circumstances in which the Rule should still protect the business judgment of directors, this Article limits itself to the argument that, in almost all cases, a board's decision relating to executive compensation has nothing to do with its prospective business plans and thus should not be afforded the protections of the Rule. This Article addresses corporate governance regulations developed through state law. Congress responded to the corporate governance crisis associated with collapses at Enron, WorldCom, and other companies by enacting the Sarbanes Oxley Act in 2002.[161]

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158. *See* Romano, *supra* note 82, at 84 ("The principal beneficiaries of [shareholder derivative] litigation therefore appear to be attorneys, who win fee awards in 90 percent of settled suits.").

159. *See id.* at 57 ("Because D&O insurers reimburse both sides' expenses in a settlement, unlike other civil litigation, in shareholder suits neither party internalizes litigation costs. A corporation's insurance premium may well rise following a lawsuit, but this cost is borne by all of the shareholders, rather than the litigating parties.").

160. *See id.* at 84 (concluding that an empirical study of shareholder suits brought from the 1960s through 1987 provided little evidence that such suits deterred misconduct by corporate managers).

161. Pub. L. No. 107-204, 116 Stat. 745 (codified as amended in scattered sections of 11, 15, 18 & 29 U.S.C. (Supp. 2005)). For an excellent, detailed discussion of the impact of Sarbanes Oxley on the law of corporate governance and directors' fiduciary duties, see Nadelle Grossman, *Director Compliance with Elusive Fiduciary Duties in a Climate of Corporate Governance Reform*, 12 FORDHAM J. CORP. & FIN. L. (forthcoming 2007).

III. The Rule and Forced Disclosure of Business Plans

A. *The Need To Protect Corporations Against Forced Disclosure*

Litigation is expensive. Shareholder derivative litigation is especially expensive.[162] But the cost is unacceptably high when a corporation might be forced to reveal its business plans in order to respond to the discovery requests of a plaintiff or plaintiff class.

Conceived as an abstention doctrine, one purpose of the Rule is to get suits dismissed before the corporation is forced to produce confidential documents in discovery. The Rule is thus deployed in the interests of the corporation rather than in the interests of its directors. It protects the corporation and the confidential decision-making processes through which boards run corporations. Treating the Rule either as an evidentiary presumption or a standard of review only protects directors from liability; it does nothing to protect corporations from exposure to damaging litigation. However, the Rule should not be used to head off all litigation against corporate defendants; absent the Rule's protections, litigation can serve as an effective constraint on corporate directors helping to enforce the duty of care.

Only when litigation requires disclosure of prospective business plans should courts invoke the Rule as an abstention doctrine. In those circumstances, a court should inquire only into whether the board's decision-making process was proper, and, if so, the court should eschew any substantive evaluation of the board's decision. If the Rule is applied in such a manner, it will achieve the goal of protecting the corporation from undue intrusion into its internal matters.

1. Mergers and Acquisitions

Decisions about mergers and acquisitions often involve life-and-death decisions about the future of a corporation.[163] Challenging a board in the process of considering its merger and/or acquisition options would clearly require the disclosure of information crucial to the corporation's prospective business plans. In such circumstances,

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162. *See id.* at 58 (stating that shareholder suits "are the largest and most expensive category of claims filed against directors and officers"). One of the key reasons why shareholder derivative litigation is a weak check on the power of corporate managers is such litigation is so expensive. Bainbridge, *supra* note 93, at 568 n.101.

163. *See, e.g.*, SEC v. Geon Indus., Inc., 531 F.2d 39, 47 (2d Cir. 1976) ("[A] merger ... is the most important event that can occur in a small corporation's life, to wit, its death ...."); Alessi v. Beracha, 849 A.2d 939, 949 (Del. Ch. 2004) (describing a transaction in which the Sara Lee Corporation would purchase the Earthgrains Company as the most important transaction in Earthgrains' short life "'to wit, its death'").

the Rule should apply to protect the corporation from having to disclose all information other than information relating to the propriety of the board's decision-making processes. It is possible that even after a merger or acquisition has been completed, the substantive rationale underlying the relevant business decisions should be protected by the Rule as the merger or acquisition in question might be merely one step in a larger business plan that will entail future transactions. In most cases, therefore, involving challenges to a board's decision relating to mergers or acquisitions, courts should invoke the Rule as an abstention doctrine and limit themselves to reviewing only the procedural propriety of the board's decision-making process in relation to the transaction.

2. Dividend Policies

Dodge[164] is most commonly cited to illustrate the principle of shareholder primacy.[165] The Ford Motor Company lost the part of that case relating to Henry Ford's decision not to issue large dividends because Henry Ford testified he wanted to invest in the company in order to "'employ still more men, to spread the benefits of this industrial system to the greatest possible number, to help them build up their lives and their homes.'"[166] The court ordered Ford to issue a large dividend to its shareholders because Henry Ford could not be permitted to continue the corporation "as a semi-eleemosynary institution."[167] Admonishing Mr. Ford, the court noted that "[a] business corporation is organized and carried on primarily for the profit of the stockholders."[168] The case was wrongly decided in my view, not because the court was wrong about shareholder primacy, but because Henry Ford understood that he could not testify truthfully about his reasons for not issuing a large dividend to Ford's shareholders without revealing prospective business plans and his

164. Dodge v. Ford Motor Co., 170 N.W. 668 (Mich. 1919).

165. *See, e.g.*, Reuven S. Avi-Yonah, *The Cyclical Transformations of the Corporate Form: A Historical Perspective on Corporate Social Responsibility*, 30 DEL. J. CORP. L. 767, 769 n.8 (2005) (calling *Dodge* the classic affirmation of the shareholder-primacy doctrine); Nathan Oman, *Corporations and Autonomy Theories of Contract: A Critique of the New* Lex Mercatoria, 83 DENV. U. L. REV. 101, 135 (2005) ("The *locus classicus* for the shareholder primacy norm is *Dodge* . . . ."); Edward B. Rock, *Corporate Law Through an Antitrust Lens*, 92 COLUM. L. REV. 497, 520 (1992) ("*Dodge* has long been considered the preeminent example of the shareholder primacy view of the corporation . . . .").

166. *Dodge*, 170 N.W. at 683.

167. *Id.*

168. *Id.* at 684.

concerns regarding the threat of competition from the Dodge brothers, who held a ten percent interest in Ford.[169]

A few years before the Dodge brothers brought their suit against Ford, they had stopped supplying Ford with parts and began to build their own cars to compete with Ford.[170] At the same time, John Dodge stepped down from Ford's board after having served as a director for ten years.[171] Henry Ford had very real concerns about the prospect that the Dodge brothers might use their dividends from his company to launch a rival corporation that would endanger Ford's ability to generate profits for its shareholders in the future.[172] This is precisely the situation in which the Rule, as an abstention doctrine, should apply, because Henry Ford's decision to resist paying out large dividends to shareholders was based on his concerns about competition from the Dodge brothers, concerns he reasonably believed he could not disclose without doing harm to his company.

But it by no means will always be the case that decisions relating to dividend policies will relate to a corporation's prospective business plans and thus be entitled to the Rule's protections. For example, in the notorious *Kamin v. American Express Co.*, American Express decided to issue to its shareholders a one-time, in-kind dividend of stock in Donaldson, Lufkin, and Jenrette (DLJ), which had declined significantly in value while in American Express' possession.[173] Plaintiffs criticized the American Express board's decision to issue the in-kind dividend on the ground that American Express thereby lost the tax benefit it might otherwise have gained by selling the stock and realizing the capital loss.[174] The board argued that taking such a loss would have hurt the value of the stock, but the vast majority of scholars agree with plaintiffs that the company's stock price already reflected the decline in the value of the DLJ stock, and thus the issuance of the in-kind dividend was, at-best, poorly informed from the

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169. *Id.* at 669-70.

170. D. Gordon Smith, *The Shareholder Primacy Norm*, 23 J. CORP. L. 277, 316 (1998).

171. *Id.*

172. *See Dodge*, 170 N.W. at 671-72. The opinion reproduced a letter from the Dodge brothers asking Henry Ford to "'advise us by early mail as to whether there is any foundation for the rumors referred to and that plans for the extension or expansion of the operations of business of the company that would absorb any considerable part of the company's present resources, are under consideration and the status of any negotiations relating thereto.'" *Id.* at 672.

173. Kamin v. Am. Express Co., 383 N.Y.S.2d 807, 809 (N.Y. Sup. Ct.), *aff'd*, 387 N.Y.S.2d 993 (N.Y. App. Div. 1976).

174. *Id.* at 809-10.

perspective of the efficient-capital-markets hypothesis.[175] The court deferred to the board's decision under the Rule.[176] This decision seems to have had nothing to do with the company's prospective business plans, and the discovery attendant to the case revealed nothing about the company that was not already public knowledge. The board seems to have made a bad decision, and there is no reason why it should not be held liable if that decision was a negligent one.[177]

3. Application to Questions of Executive Compensation

What sort of a business judgment is the decision to provide for a certain sort of pay package for a corporate executive? In practice, decisions on executive compensation are delegated to a compensation committee rather than being addressed by the board as a whole.[178] The

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175. *See, e.g.*, Edward B. Rock & Michael L. Wachter, *Islands of Conscious Power: Law, Norms, and the Self-Governing Corporation*, 149 U. PA. L. REV. 1619, 1672 (2001) (characterizing the board's decision as "a pretty dumb one"); Franklin A. Gevurtz, *Getting Real About Corporate Social Responsibility: A Reply to Professor Greenfield*, 35 U.C. DAVIS L. REV. 645, 657 n.33 (2002) (characterizing the board's decision as having cost the company $8 million); Eric Talley, *Taking the "I" Out of "Team": Intra-Firm Monitoring and the Content of Fiduciary Duties*, 24 J. CORP. L. 1001, 1009 (1999) (characterizing the board's decision as "almost certainly misguided"); Elliott J. Weiss, *Teaching Accounting and Valuation in the Basic Corporation Law Course*, 19 CARDOZO L. REV. 679, 691 (1997) (noting that the board action did not serve shareholders interests, because "any investor interested in American Express would have found it very easy to learn that American Express had in fact incurred [a] loss" on its DLJ stock).

176. *See Kamin*, 383 N.Y.S.2d at 811 ("It is not enough to allege, as plaintiffs do here, that the directors made an imprudent decision, which did not capitalize on the possibility of using a potential capital loss to offset capital gains. More than imprudence or mistaken judgment must be shown.").

177. Some scholars also point to *Kamin* as evidence that corporate managers are encouraged to engage in questionable accounting practices. *See, e.g.*, Lawrence A. Cunningham, *Sharing Accounting's Burden: Business Lawyers in Enron's Dark Shadows*, 57 BUS. LAW. 1421, 1447 (2002) ("The *Kamin* board's decision suggests that it was more important to make decisions yielding superior accounting (maximizing income) than superior economics (maximizing after-tax dollars)."); Gevurtz, *supra* note 28, at 1262 ("[T]he court held that it was entirely appropriate . . . for the directors of American Express to cause the company to lose millions of dollars for the sole purpose of improving reported earnings and thereby maintaining the price at which the company's stock traded."); Daniel J.H. Greenwood, *Discussing Corporate Misbehavior: The Conflicting Norms of Market, Agency, Profit and Loyalty*, 70 BROOK. L. REV. 1213, 1226 & n.16 (2005) (describing the *Kamin* court as condoning cooking the books to inflate the company's apparent value); Daniel J.H. Greenwood, *Enronitis: Why Good Corporations Go Bad*, 2004 COLUM. BUS. L. REV. 773, 821 n.89 ("[T]he [*Kamin*] court rested its decision solely on the astonishing rationale offered by management: deceiving investors was good for them.").

178. *See* BEBCHUK & FRIED, *supra* note 47, at 24 ("Boards of large public companies delegate to compensation committees the task of working out the critical details of executive compensation arrangements."); Jeffrey N. Gordon, *Executive Compensation: If There's a Problem, What's the Remedy? The Case for "Compensation Discussion and Analysis,"* 30 J.

compensation committee, in turn, relies on the advice of a compensation expert.[179] Those experts are hired through processes that the CEO is able to influence.[180] The chosen experts therefore have no incentive to look out for shareholder interests and every incentive to use their discretion in favor of executives.[181] Often boards of directors do not even meet with the consultants on whose opinions they purportedly rely.[182]

Directors speaking under conditions of anonymity acknowledge the conflict of interest at the heart of the business of compensation experts.[183] One noted that "consultants are hired by management. They're going to be rehired by management."[184] Another remarked that "[t]he basic goal of compensation consultants is to justify whatever it is the CEO wants to make. After all, who's going to recommend these consultants to other CEOs?"[185]

The basic process seems to be fundamentally one-sided, with no elements of input weighing in on the side of reining in executive pay. When boards set compensation levels, they look to compensation levels at firms they view as comparable, and they are unlikely to view

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CORP. L. 675, 689 (2005) ("[B]oards increasingly have devolved the responsibility for executive compensation to a specific compensation committee.").

179. Randall S. Thomas, *Explaining the International CEO Pay Gap: Board Capture or Market Driven?*, 57 VAND. L. REV. 1171, 1191 (2004) ("To assist it in performing its tasks, the Compensation Committee will usually retain the services of an expert compensation consultant.").

180. *See* BEBCHUK & FRIED, *supra* note 47, at 38 ("Typically, consultants have been hired through a firm's human resources department, and CEOs have often been involved in the selection process.").

181. *See id.* (noting consultants are not beholden in any way to shareholders and "could only benefit from using their discretion to favor the CEO").

182. Roundtable, *What's Wrong with Executive Compensation?*, HARV. BUS. REV., Jan. 2003, at 68, 71 (statement of John England, Compensation Consultant) ("But in almost 20 years of consulting at the board level, I've only seen a handful of committees regularly call executive sessions with the compensation consultant.").

183. *See* Carol J. Loomis, *'This Stuff Is Wrong,'* FORTUNE, June 25, 2001, at 73, 74.

184. *Id.*

185. *Id.* at 80; *see* Ryan Miske, Note, *Can't Cap Corporate Greed: Unintended Consequences of Trying To Control Executive Compensation Through the Tax Code*, 88 MINN. L. REV. 1673, 1696 (2004) ("Without compensation committees composed solely of independent directors who assess the worth of the company's executives at arm's length, compensation caps will simply be circumvented with the assistance of creative lawyers, accountants, and compensation experts."); Mark A. Salky, Comment, *The Regulatory Regimes for Controlling Excessive Executive Compensation: Are Both, Either, or Neither Necessary?*, 49 U. MIAMI L. REV. 795, 800 (1995) ("Essentially, CEOs set their own salaries through the use of a submissive board of directors as well as clever compensation consultants who draft compensation packages around the various restraints established for curbing excessive pay.").

the CEO they want to hire or retain as merely average.[186] As one former CEO put it, "[t]he main reason compensation increases every year is that most boards want *their* CEO to be in the top half of the CEO peer group, because they think it makes the company look strong."[187]

Even those who seek reform of executive compensation offer few strategies that would change the dynamic whereby corporate executives sit on corporate boards and pay their peers salaries in line with what they in turn would want to be paid.[188] And the problem of executive compensation only becomes worse with the advent of generous options packages. As one former executive summarized his experience:

> Let's say a board is discussing whether to award the CEO options on 2 million shares. During the conversation, somebody points out that the options aren't going to be an expense, so they won't cost the company anything when they're granted. Someone else picks up on that and says, "In that case, why not give the CEO options on 4 million?"[189]

Some have placed hope for reform in the advent of independent compensation committees, but people with experience on corporate boards dismiss the notion that boards or compensation committees can truly be independent of CEOs.[190]

In designing pay packages, consultants draw on nonpublic pay data companies make available to them and they agree to keep confidential.[191] The companies have an incentive to share this information with compensation consultants because the information assists the consultants in improving the design of executive

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186. Gordon, *supra* note 178, at 687.

187. *What's Wrong with Executive Compensation?*, *supra* note 182, at 72 (statement of Edgar S. Woolard, Jr., former CEO of DuPont).

188. *See id.* at 70 (statement of Eric Roiter, Senior Vice President and General Counsel, Fidelity Mgmt. & Research Co.) ("The test might be based on benchmarks for peer groups and adjusted to temper the spread between the pay of the most senior officers and that of the rank and file.").

189. *Id.* (statement of Peter Clapman, Senior Vice President and Chief Counsel for Investments, TIAA-CREF).

190. *See id.* at 71 ("Ultimately, the CEOs of public corporations still have a lot of power over the process, over the selection of directors, over the decisions of compensation committees."); *id.* at 72 (statement of Edgar S. Woolard, Jr.) (characterizing as a "myth" the notion that compensation committees are independent); *see also* BEBCHUK & FRIED, *supra* note 47, at 81 (noting that large boards, having outside directors who sit on multiple boards, and interlocking directorates all make it less likely that the board will be independent of the CEO).

191. *See What's Wrong with Executive Compensation?*, *supra* note 182, at 70.

compensation.[192] Thus, when boards rely on compensation experts to set executive compensation, their decision does not involve any confidential information relating to the company on whose board they sit. In fact, such decisions are usually based on information relating to *other* companies. In such circumstances, litigation challenging board decisions regarding executive pay does not threaten the corporation with forced disclosure of prospective business plans, and the Rule should not apply.

B. The Rule and the Disney Litigation

The growth of executive pay in the United States since the 1990s has been simply breathtaking. In 1991, the average large-company CEO outearned the average worker by a factor of 140; by 2003, the ratio was 500:1.[193] Although executives account for a very small percentage of a corporation's employees, their compensation accounts for a large portion of a corporation's expenditures.[194] Between 1998 and 2002, the 1500 companies in the ExecuComp database paid about $100 billion to their top 5 executives.[195] In 2003, compensation to the top 5 executives in all public companies in the previous 3 years equaled 10% of those companies' earnings.[196]

A 1992 study found that, going back to 1900, courts have almost never overturned decisions relating to compensation for executives at publicly traded companies.[197] As of 1996, there were almost no rulings by appellate courts affirming an order to reduce executive compensation at a public company based on a theory of waste.[198] There is considerable evidence that boards are never really actually independent when they decide on executive compensation, and so the most straightforward argument against the use of the Rule in the context of executive compensation is simply that even under traditional justifications of the Rule, the fact that most board members are beholden to the CEO creates a conflict of interest that should preclude

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192. *Id.*

193. BEBCHUK & FRIED, *supra* note 47, at 1.

194. Bainbridge, *supra* note 112, at 1619.

195. *Id.*

196. Gretchen Morgenson, *Behind Every Underachiever, An Overpaid Board?*, N.Y. TIMES, Jan. 22, 2006, § 3, at 1.

197. Linda J. Barris, *The Overcompensation Problem: A Collective Approach to Controlling Executive Pay*, 68 IND. L.J. 59, 81-82 (1992).

198. Mark J. Loewenstein, *Reflections on Executive Compensation and a Modest Proposal for (Further) Reform*, 50 SMU L. Rev. 201, 214-15 (1996).

the use of the Rule.[199] Even defenders of high executive compensation acknowledge that the problem of structural bias in favor of high compensation is intractable:

> We are dealing with people, by and large, who know one another and have common experiences, and it's not an environment likely to foster a great deal of independence from the CEO among board members. And in trying to create independence, you do not want to create an adversarial relationship.[200]

However, courts have repeatedly rejected plaintiffs' claims that the Rule should not be applied to executive compensation cases based on directors' professional indebtedness to the CEO.[201]

Making the Rule inapplicable to decisions relating to executive compensation is not the only solution to the problem of executive pay. Recently, the Securities and Exchange Commission (SEC) has proposed new disclosure rules relating to executive pay.[202] Others have suggested the SEC go further and require shareholder approval of the pay packages the SEC would require corporations to disclose.[203] But

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199. *See* BEBCHUK & FRIED, *supra* note 47, at 27-36 (identifying CEOs' power to benefit directors through interlocking boards, and the CEO power to set levels of director compensation, social and psychological factors that prevent directors from challenging CEOs, and the small cost to directors of favoring executives preventing arms-length negotiation of executive compensation).

200. *What's Wrong with Executive Compensation?*, *supra* note 182, at 71 (statement of Joe Bachelder, Executive Compensation Lawyer, Bachelder Law Firm); *see* BEBCHUK & FRIED, *supra* note 47, at 80 (summarizing factors that increase CEO influence over a board).

201. *See In re* Walt Disney Co. Derivative Litig., 907 A.2d 693, 761 n.488 (Del. Ch. 2005), *aff'd*, 906 A.2d 27 (Del. 2006) (noting that Disney CEO, Michael Eisner, surrounded himself with "yes men" and "non-employee directors who would have sycophantic tendencies" but nonetheless concluding that the board had exercised independent judgment). In a recent shareholder derivative action alleging breach of fiduciary duty based on a failure of oversight by the board of Martha Stewart Living Omnimedia, the Delaware Supreme Court found demand was not excused because a majority of the directors were independent of Martha Stewart despite the fact that they had long been friends with her and/or done business with her. Beam *ex rel.* Martha Stewart Living Omnimedia, Inc. v. Stewart, 845 A.2d 1040, 1050-55 (Del. 2004). *But see* Pereira v. Cogan, 294 B.R. 449, 517, 528 (S.D.N.Y. 2003) (holding directors liable for failure of oversight of executive compensation after finding the corporation's two-member compensation committee lacked independence). *See generally* Kenneth B. Davis, Jr., *Structural Bias, Special Litigation Committees, and the Vagaries of Director Independence*, 90 IOWA L. REV. 1305, 1310 (2005) ("The overwhelming majority of courts . . . have rejected the structural-bias concept.").

202. *See* Stephen Labaton, *S.E.C. To Require More Disclosure of Executive Pay*, N.Y. TIMES, Jan. 18, 2006, at A1 (reporting proposed new rules would require public corporations to provide "a figure for total compensation, including significant perks, stock options and retirement benefits" for the five top-paid executives).

203. Gordon, *supra* note 178, at 693-701 (calling on the SEC to require proxy disclosure of a "Compensation Discussion and Analysis" and urging consideration of a

there seems to be little hope that such reforms will have a large impact on executive pay.[204]

1. The Problem of Pay Without Performance

As their critics acknowledge, Harvard's Lucian Bebchuk and Berkeley's Jesse Fried (and their collaborators) have made a significant contribution to our understanding of executive compensation.[205] Their fundamental insight is that "[t]he absence of effective arm's-length dealing under today's system of corporate governance . . . has been the primary source of problematic compensation arrangements."[206] One consequence of the fact that executive compensation does not result from arm's-length negotiations is that executive cash compensation "has been at best weakly correlated with firms' industry-adjusted performance" and other forms of executive compensation, including favorable loans, pensions, deferred compensation, and perks, "have tended to be insensitive to managerial performance."[207] In fact, one recent study found highly paid CEOs who run large firms and are not subject to monitoring by large shareholders perform worse than their more poorly paid peers.[208]

The fact that executive compensation packages are extraordinarily generous does not necessarily mean that they are excessive.[209]

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shareholder approval vote on that disclosure, a practice recently adopted in the United Kingdom).

204. *See* Labaton, *supra* note 202, at A1 (noting proposed new SEC rules are not expected to have much of an impact on executive pay).

205. Gordon, *supra* note 178, at 677 (articulating concerns about Bebchuk and Fried's book); Bainbridge, *supra* note 112, at 1618 ("[Bebchuk and Fried's text] makes a significant and valuable contribution to the literature by synthesizing and systematizing the managerialist account of executive compensation."); William W. Bratton, *The Academic Tournament over Executive Compensation*, 93 CAL. L. REV. 1557, 1561 (2005) (reviewing BEBCHUK & FRIED, *supra* note 47) (acknowledging the reform called for by Bebchuk and Fried will not occur anytime soon but praising their "robust criticism" of current boardroom practices); John E. Core et al., *Is U.S. CEO Compensation Inefficient Pay Without Performance?*, 103 MICH. L. REV. 1142, 1142 (2005) (reviewing same) ("Professors Lucian Bebchuk and Jesse Fried develop and summarize the leading critiques of current executive compensation practices in the United States." (footnotes omitted)).

206. BEBCHUK & FRIED, *supra* note 47, at ix.

207. *Id.* at 7; *see* Michael B. Dorff, *Does One Hand Wash the Other? Testing the Managerial Power and Optimal Contracting Theories of Executive Compensation*, 30 J. CORP. L. 255, 290 (2005) (concluding that managerial power over directors dramatically impacts executive compensation).

208. Lewis A. Kornhauser et al., *The Good, the Bad and the Lucky: CEO Pay and Skill* 6 (N.Y. Univ. Sch. of Law, N.Y. Univ. Law & Econ. Working Papers, No. 9, 2005), *available at* http://lsr.nellco.org/nyu/lewp/papers/9.

209. *See* BEBCHUK & FRIED, *supra* note 47, at 8 (distinguishing their approach from "moral," "fairness-based," or "populist" opposition to high executive compensation). *But see*

However, from the perspective of this Article, it does not matter whether it makes sense generally for executives to be generously compensated. What matters is that executive compensation constitutes a significant corporate expenditure. The question is whether there is any reason to use the Rule to protect directors who make poor decisions regarding executive compensation from liability in connection with those decisions. From that perspective, Bebchuk and Fried's work on the disconnect between executive pay and performance is of great significance, even if we believe that highly competent or successful executives are entitled to extremely generous compensation packages.

Bebchuk and Fried have identified four ways in which standard executive compensation contracts create perverse incentives and reward executives regardless of performance, while preventing shareholders from knowing the details of executive compensation.[210] Boards that approve such executive contracts should not be permitted the deference accorded to other sorts of decisions under the Rule.

First, executive compensation contracts now routinely reward executives for reporting higher earnings, creating an incentive for executives to boost their numbers.[211] However, when, as in the case of Fannie Mae, those numbers turn out to be grossly misstated, executive compensation contracts do not provide for a downward adjustment of compensation commensurate with the overstatement of earnings.[212] Second, executives who resign in disgrace receive extremely generous compensation packages, as long as they have not been fired for "cause," a term that is narrowly defined in standard executive compensation contracts.[213] Third, largely in order to avoid the tax

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Gordon, *supra* note 178, at 677 (contending that the outrage caused by executive compensation is not explained by the disconnect between pay and performance alone).

210. *See* Bebchuk & Fried, *supra* note 126, at 807-08 (outlining four problems with Fannie Mae's executive pay arrangements).

211. *Id.* at 809-12.

212. *Id.* at 810.

213. *Id.* at 812. For example, Fannie Mae's CEO, Franklin Raines, who was dismissed in an accounting scandal, received a retirement package worth at least $32 million. *Id.* Fannie Mae's CFO, Timothy Howard, received a $6 million pension. *Id.* The authors note that "poor operating performance, deception, or earnings manipulation that falls short of the legal definition of fraud are not grounds for a for cause termination" under Raines and Howard's contracts. *Id.* Moreover, under Fannie Mae executives' contracts, had they been dismissed for "cause," Raines' severance package would have been reduced by only $7 million and Howard's package would not have been reduced at all. *Id.* at 813; *see In re* Walt Disney Co. Derivative Litig., 907 A.2d 693, 759 (Del. Ch. 2005), *aff'd*, 906 A.2d 27 (Del. 2006) (upholding the board's determination that Michael Ovitz could not be terminated "for cause").

implications of nonperformance-based executive salaries in excess of $1 million,[214] corporations circumvent this limit by providing generous retirement benefits that are not linked to performance.[215]

Finally, corporations use postretirement payments to camouflage large amounts of compensation that are not based on performance.[216]

> [C]ompensation arrangements have often been designed with an eye to camouflaging rent and minimizing outrage. Firms have systematically taken steps that make less transparent both the total amount of compensation and the extent to which it is decoupled from managers' own performance. Managers' interest in reduced transparency has been served by the design of numerous compensation practices, such as postretirement perks and consulting arrangements, deferred compensation, pension plans, and executive loans.[217]

In the context of executive compensation, the camouflage argument is the best response to the corporate sovereignty defense of the Rule.[218] Boards cannot be held accountable to shareholders if they do not disclose the nature of executive compensation, and when they design executive contracts so as to circumvent shareholder oversight, they should not be entitled to the protections of the Rule. But retirement payments are not the only aspect of executive compensation that is camouflaged. "[U]ntil very recently, SEC rules haven't required companies to disclose the scope or even the existence of option plans that haven't been approved by shareholders."[219]

2. Application in the *Disney* Case

In January 1997, plaintiffs brought a claim against Disney and its directors for a breach of fiduciary duty in connection with the hiring of Ovitz to be Disney's President in 1995 and in connection with the

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214. I.R.C. § 162(m) (2000).

215. BEBCHUK & FRIED, *supra* note 47, at 92-93; Bebchuk & Fried, *supra* note 126, at 816; Lucian Arye Bebchuk & Jesse M. Fried, *Stealth Compensation via Retirement Benefits*, 1 BERKELEY BUS. L.J. 291, 295 (2004).

216. BEBCHUK & FRIED, *supra* note 47, at 95-111; Bebchuk & Fried, *supra* note 126, at 816-21; Bebchuk & Fried, *supra* note 215, at 316-19.

217. BEBCHUK & FRIED, *supra* note 47, at 6.

218. The camouflage argument does not only apply to the question of executive compensation. As Gevurtz has suggested, the *Kamin* court applied the Rule to prevent American Express directors from facing liability for issuing a dividend to shareholders that prevented the company from realizing an $8 million tax savings. Gevurtz, *supra* note 28, at 1267-68. Worse still, the court never questioned the business practice that cost shareholders $8 million that was to hide a significant loss on a failed investment rather than disclosing the loss. *Id.*

219. Roundtable, *supra* note 182, at 71 (statement of Jamie Heard, CEO, Institutional Shareholder Servs.).

Disney board's approval of a $140 million severance payment in connection with Ovitz's termination late in 1996.[220] The case has now been argued twice before the Delaware Supreme Court.[221] Its facts and history illustrate the problems with utilizing the Rule to shield directors from liability challenges to a board's approval of executive compensation plans.

a. The Facts of the *Disney* Case

In late summer 1995, Disney CEO, Michael Eisner, and Ovitz negotiated an Employment Agreement (the OEA) whereby Ovitz, who was a close friend of Eisner,[222] would become President of Disney and Eisner's second-in-command. The only members of Disney's board of directors who were informed of and participated in the negotiations were Irwin Russell, who was then chairman of Disney's compensation committee, and Raymond Watson, another member of the compensation committee.[223] Russell was also Eisner's personal attorney.[224] A compensation expert, Graef Crystal, was consulted during the negotiations, performed various calculations, and prepared spreadsheets evaluating the compensation packages being considered for Ovitz.[225] Eisner's employment agreement, along with that of Ovitz's predecessor, Frank Wells, served as a template for the OEA.[226] Russell cautioned that Ovitz's level of compensation and the number of stock options being offered to him went "far beyond the standards applied within Disney and corporate America."[227] Crystal also expressed concern about the magnitude of Ovitz's pay package, as well

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220. *See* Brehm v. Eisner, 746 A.2d 244, 248-49 (Del. 2000) (summarizing plaintiffs' claims: (1) the Disney board breached its fiduciary duty in approving an "extravagant and wasteful Employment Agreement" with Ovitz; (2) the Disney board breached its fiduciary duty in agreeing to an "extravagant and wasteful" nonfault termination of Ovitz; and (3) the directors were not disinterested and independent).

221. The case was affirmed by the Delaware Supreme Court on June 8, 2006. *In re* Walt Disney Co. Derivative Litig., 906 A.2d 27 (Del. 2006).

222. *See Brehm*, 746 A.2d at 249; *In re* Walt Disney Co. Derivative Litig., 907 A.2d 693, 699-706 (Del. Ch. 2005); *aff'd*, 906 A.2d 27.

223. *In re Disney*, 907 A.2d at 702.

224. *Id.* at 747 n.488.

225. *Id.* at 704-05.

226. *Id.* at 703.

227. *Id.* at 704.

as the incentives it created.[228] It appears Russell and Crystal's concerns were never shared with Disney's board of directors.[229]

On August 14th, 1995, having discussed the matter with only a few members of Disney's board of directors, Eisner entered into a letter agreement with Ovitz (OLA), outlining the basic terms of his employment.[230] Although the OLA provided that it was subject to approval by the compensation committee and the board, Disney issued a press release the day the OLA was signed, making Ovitz's hiring a matter of public knowledge.[231] Ovitz was hired over the strenuous objections of at least three of Disney's inside directors, and Ovitz's hiring was therefore made conditional on his concession that two of his supposed subordinates would report directly to Eisner.[232]

The terms of Ovitz's employment were approved during a one-hour meeting of Disney's compensation committee at which it was one of five matters on the agenda.[233] Crystal did not attend the meeting, and neither the OEA nor his analysis of the OEA were distributed to the compensation committee.[234] Instead, Russell and Watson summarized Crystal's analysis.[235] The compensation committee did not consider the following terms of the OEA:

> (1) the purchase of Ovitz's private jet for $187,000 over the appraised value; (2) the purchase of Ovitz's BMW at acquisition cost and not the depreciated market value; (3) the purchase of Ovitz's computers at replacement value instead of their lower book value; (4) any specific list of perquisites, despite Eisner already agreeing to provide Ovitz with numerous such benefits; and (5) that despite Ovitz's bonus being payable completely on a discretionary basis, Russell's memorandum to

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228. *See id.* at 705 ("Crystal was philosophically opposed to a pay package that would give Ovitz the best of both worlds—*i.e.*, low risk and high return.").

229. Only Eisner heard of Russell's concerns. *See id.* at 704 ("Russell did not provide this Case Study [outlining the OEA parameters] to any other member of Disney's board of directors."); *id.* at 705-06 ("Crystal's letter was never circulated to any board member other than Eisner.").

230. *Id.* at 707.

231. *Id.* at 708.

232. *See* Brehm v. Eisner, 746 A.2d 244, 250 (Del. 2000) ("When Eisner told three members of the Old Board in mid-August 1995 that he had decided to hire Ovitz, all three 'denounced the decision.'"); *In re Disney*, 907 A.2d 693, 706 (reporting that Disney's General Counsel and Chief Operating Officer Sanford Litvack and Chief Financial Officer Stephen Bollenbach immediately made it clear that they would not report to Ovitz but would continue to report to Eisner).

233. *In re Disney*, 907 A.2d 693, 708. One of those items was the approval of a $250,000 payment to Russell for his role in negotiating Ovitz's contract. Appellants' Opening Brief, *supra* note 62, at 11.

234. *In re Disney*, 907 A.2d 693, 709.

235. *Id.*

> Ovitz indicating that the bonus would likely approximate $7.5 million annually.[236]

Immediately after the compensation committee meeting, Disney's board of directors heard Watson explain his analysis of the OEA, and he and Russell responded to the board's questions on the matter.[237] The board then voted unanimously to elect Ovitz as Disney's president.[238]

Although there is some dispute as to this matter, the court concluded that Eisner was generally positive about Ovitz's performance during his first few months at Disney.[239] However, matters deteriorated quickly in 1996.[240] By the fall of 1996, it was clear to all but Ovitz that he had no future at Disney.[241] The OEA provided for three possible ways by which Ovitz might be terminated:

> He might serve his five years and Disney might decide against offering him a new contract. If so, Disney would owe Ovitz a $10 million termination payment. Before the end of the initial term, Disney could terminate Ovitz for "good cause" only if Ovitz committed gross negligence or malfeasance, or if Ovitz resigned voluntarily. Disney would owe Ovitz no additional compensation if it terminated him for "good cause." Termination without cause (non-fault termination) would entitle Ovitz to the present value of his remaining salary payments through September 30, 2000, a $10 million severance payment, an additional $7.5 million for each fiscal year remaining under the agreement, and the immediate vesting of the first 3 million stock options (the "A" Options).[242]

Eisner had General Counsel and Chief Operating Officer Sanford Litvack look into the possibility of terminating Ovitz for cause, but he and Litvack both concluded that cause was lacking.[243] It is not clear that the issue of for-cause termination was ever raised with Disney's board.[244]

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236. *Id.* at 709 n.85.

237. *Id.* at 710.

238. *Id.*

239. *See id.* at 713 n.120 (citing three letters from Eisner written late in 1995 indicating Eisner's favorable impressions of Ovitz's performance at that time and finding not credible the contrary testimony of Sid Bass, then Disney's largest shareholder).

240. *Id.* at 724.

241. *Id.*

242. Brehm v. Eisner, 746 A.2d 244, 250 (Del. 2000) (footnote omitted).

243. *In re Disney*, 907 A.2d at 728-29.

244. *See id.* at 731 (noting that "there is some controversy as to whether any details of the NFT and the cause question were discussed" at the November 25, 1996, executive session at which Eisner announced his intention to fire Ovitz by year's end).

After reviewing the various accounts of Ovitz's performance, the court concluded there were "three competing theories as to why Ovitz was not successful."[245] However, for the purposes of determining whether defendants could be held liable for breach of the duty of care in connection with Ovitz's hiring and firing, the court remarked that "it makes no difference why Ovitz was not as successful as his reputation would have led many to expect, so long as he was not grossly negligent or malfeasant."[246]

The court relegated to the footnotes the testimony most relevant to plaintiffs' claim that defendants breached their fiduciary duties and committed waste by paying Ovitz a severance package worth approximately $140 million based on a no-fault termination (NFT) when there was evidence Ovitz justifiably could have been terminated for cause. For example, Eisner wrote of Ovitz: "I do not trust him. None of the people he works with feels comfortable with his directness and honesty.... The biggest problem is that nobody trusts him, for he cannot tell the truth."[247] The court suggested that this writing did not reflect Eisner's true feelings about Ovitz because it was written shortly after Eisner's mother's death.[248] In a later letter, explaining the reasons for Ovitz's termination, which was drafted but never sent to Ovitz, Eisner wrote, "When we talked last Friday, I told you again that my biggest problem was that you played the angles too much. I told you 98% of the problem was that I did not know when you were telling the truth, about big things, about small things ...."[249] Still, the court adopted a benign reading of Eisner's view of Ovitz; namely, that Ovitz had a tendency to engage in "salesmanship" or "agenting" and would thus stretch the truth in order to get his way.[250]

After Ovitz's termination was announced, Eisner sent an e-mail to Disney's head of public relations in which he called Ovitz "totally

245. *Id.* at 718.

246. *Id.*

247. *Id.* at 720 n.186.

248. *Id.* at 720.

249. *Id.* at 727. The opinion omitted "'exaggerated the truth too far, manipulated me and others too much.'" Appellants' Opening Brief, *supra* note 62, at 1. The court omits the next sentence: "'And while you were telling me that those dishonest days were over, you were deceiving me on a specific matter.'" *Id.* at 17. The court discounts the significance of this letter because Eisner characterized it as "'not accurate, way exaggerated, silly, hyperbole.'" *In re Disney*, 907 A.2d at 727. Eisner wrote the letter as part of an attempt to "put Ovitz on notice that he was no longer welcome at Disney." *Id.* However, the letter indicates that Eisner spoke with Ovitz about his veracity problems on several occasions. *See* Appellants' Opening Brief, *supra* note 62, at 17 ("'*As we've discussed many times*, we all never knew when you were telling things the way they were.'").

250. *In re Disney*, 907 A.2d at 720.

incompetent" and a "psychopath."[251] Although at trial Eisner claims he did not even know what the words in the letter meant (a claim the court found persuasive),[252] the letter is actually quite clear on Eisner's understanding of the word "psychopath": "'He is a psychopath (Doesn't know right from wrong), cannot tell the truth. Basically he has a character problem, too devious, too untrustworthy to everybody, and only out for himself.'"[253] Similarly, Litvack testified that "Ovitz would 'handle' Litvack and 'put his spin on things,'" but the court noted the worst lies Litvack could remember were trivial fibs like: "'I was on the phone with someone important and couldn't be on time for the meeting.'"[254] The court concluded there was no concrete evidence that Ovitz ever told a material falsehood and the trivial statements attributed to Ovitz by Litvack did not suffice to constitute gross negligence or malfeasance, the standard necessary for termination "for cause."[255]

On December 10, 1996, Disney's Executive Performance Plan Committee met. Russell recommended Ovitz be granted a $7.5 million bonus despite his poor performance.[256] No member of the committee objected to this suggestion, apparently because they were under the impression that Disney was obligated to pay Ovitz a bonus, although the OEA clearly states the bonus is discretionary.[257] Two days later, Disney issued a press release announcing that Ovitz would leave the company, effective January 31, 1997.[258] At that point, "[T]he Disney board had never met in order to vote on, or even discuss, the termination ... and few if any directors did an independent investigation of whether Ovitz could be terminated for cause."[259]

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251. *Id.* at 738.

252. *Id.* (quoting Ovitz as describing the letter "as his effort at 'venting' and that 'although [he] didn't know what the words meant, [he] was just so angry'"). Though Eisner's evaluation of Ovitz as a psychopath may not rise to the level of an authoritative clinical diagnosis, his letter makes his meaning very clear, and Eisner's evaluation of Ovitz's character is significant whether or not he used the term "psychopath" correctly. If Eisner does not know what the term "totally incompetent" means, one wonders why a court should defer to his business judgment as to whether Ovitz could have been terminated for cause.

253. Appellants' Opening Brief, *supra* note 62, at 17.

254. *In re Disney*, 907 A.2d at 720.

255. *Id.* at 720 n.191.

256. *Id.* at 734.

257. *Id.* On December 20, 1996, Disney's Executive Performance Plan Committee met for the sole purpose of rescinding Ovitz's bonus. Eisner then accelerated Ovitz's departure date to December 27, 1996. *Id.* at 739.

258. *Id.* at 735.

259. *Id.* at 736.

Ovitz subsequently was awarded a severance package worth approximately $140 million.[260] Crystal later said that no one ever bothered to work out the numbers on the severance provisions in the OEA.[261] If they had, according to plaintiffs, they would have noticed that the OEA set up perverse incentives for Ovitz, permitting him to make more money if he left Disney pursuant to the NFT provision of the OEA than he could if he stayed in his position for the full five-year term.[262] Crystal described Ovitz's severance package under the OEA as "shocking."[263]

b. The Misplaced Rule

Because the Rule, bolstered by the liability protection provided by § 102(b)(7) of Delaware's General Corporation Law, applied to this case, the court found that the standard applicable to the review of the defendants' decisions relating to the hiring and firing of Ovitz was good faith: "[T]he concept of *intentional dereliction of duty, a conscious disregard for one's responsibilities*, is an appropriate (although not the only) standard for determining whether fiduciaries have acted in good faith."[264] The court, thus constrained by existing jurisprudence, was compelled to find that the defendants could not be held liable, though the Chancellor felt compelled to point out the enormous gulf separating the conduct of the Disney board from ideal practices.[265] The court was especially harsh in its characterization of Michael Eisner's management style:

260. Brehm v. Eisner, 746 A.2d 244, 248-49 (Del. 2000).

261. *See id.* at 251 (quoting Crystal as stating that "'no one added up the total cost of the severance package'"); *id.* at 261 (summarizing the complaint as alleging that "neither Crystal nor the Old Board made the calculations that Crystal—the expert—*now* believes he should have made").

262. *Id.*; *see In re Disney*, 907 A.2d at 759 (noting the plaintiffs' expert witness opined that the OEA "improperly incentivized Ovitz to leave the Company and receive an NFT, rather than complete the term of the OEA").

263. *Brehm*, 746 A.2d at 251. Chancellor Chandler described the severance payments as "breathtaking." *In re Disney*, 907 A.2d at 698.

264. *In re Disney*, 907 A.2d at 755.

265. *See, e.g.*, *id.* at 760 ("For the future, many lessons of what not to do can be learned from defendants' conduct here."); *id.* at 760 n.487 (describing the board as "supine or passive"); *id.* at 761 n.488 ("[T]he board's collective kowtowing in regard to Ovitz's hiring is also due to Eisner's desire to surround himself with yes men."); *id.* (giving examples of "Eisner's success at surrounding himself with non-employee directors who would have sycophantic tendencies"); *id.* at 763 (speaking of Eisner as "having enthroned himself as the omnipotent and infallible monarch of his personal Magic Kingdom"); *id.* at 764 (remarking that it would have been better if Russell had sought to verify Ovitz's representations as to his income from his firm, Creative Artists Agency); *id.* at 769-70 (suggesting it would have been better if the compensation committee had entertained a formal presentation from Crystal

> 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 decisionmaking abilities. Eisner stacked his (and I intentionally write "his" as opposed to "the Company's") board of directors with friends and other acquaintances who, though not necessarily beholden to him in a legal sense, were certainly more willing to accede to his wishes and support him unconditionally than truly independent directors.[266]

Although finding that Eisner acted neither with gross negligence nor in bad faith, the court noted many lapses in Eisner's conduct in connection with Ovitz's hiring:

> He failed to keep the board as informed as he should have. He stretched the outer boundaries of his authority as CEO by acting without specific board direction or involvement. He prematurely issued a press release that placed significant pressure on the board to accept Ovitz and approve his compensation package in accordance with the press release.[267]

In sum, the court concluded, Eisner's conduct did not "comport with how fiduciaries of Delaware corporations are expected to act."[268]

With respect to the rest of the board, the court did not find their conduct in connection with Ovitz's hiring commendable, but it did not violate any fiduciary duty.[269] Similarly, with respect to the decision to permit Ovitz's NFT, Disney's corporate charter permitted the board to delegate authority to make decisions in such matters to Eisner, and, so they could not have violated any duty in connection with that termination.[270] Invoking the divergence of standards of conduct and standards of care, the court concluded: "[T]he standards used to measure the conduct of fiduciaries under Delaware law are not the same standards used in determining good corporate governance."[271]

The case provides a telling illustration of the divergence of standards of conduct and standards of review under the Rule, first identified by Eisenberg.[272] In its August 2005 opinion dismissing the complaint on all counts, the Delaware Chancery Court noted that

before the board relied on his analysis); *id.* at 771 (conceding that directors Poitier and Lozano "may appear casual or uninformed").

266. *Id.* at 760-61 (footnote omitted).
267. *Id.* at 762-63.
268. *Id.* at 763.
269. *Id.* at 772.
270. *Id.* at 776.
271. *Id.* at 772
272. Eisenberg, *supra* note 6, at 440-44.

"there are many aspects of defendants' conduct that fell significantly short of the best practices of ideal corporate governance."[273] The question is, in contexts such as the Disney compensation case, does granting directors the benefits of the Rule help the corporation or help shareholders? The clear answer is the Rule accomplishes neither goal, even if we believe that, despite the bad outcome in this case, the board did the right thing in: (a) hiring (or approving the hiring of) Ovitz to be its President, (b) approving the OEA that provided for a $140 million severance payment to Ovitz after only 14 months in office, and (c) determining that Ovitz could not be fired for cause. That is, hiring Ovitz might have looked like a good idea for Disney in 1995 and offering him a generous severance package might have been necessary given that Ovitz was giving up his share in a very profitable partnership.[274] A court could also conclude that the Disney directors engaged in a reasonable inquiry and properly concluded that Ovitz could not be fired for cause in 1996.

But the Rule does not permit a court to engage in such a reasonable inquiry. Instead, a court has to excuse what it recognizes as misconduct on the part of corporate directors, whether or not that misconduct results in harm to the corporation and its shareholders: "Eisner's failure to better involve the board in the process of Ovitz's hiring, usurping that role for himself . . . does not comport with how fiduciaries of Delaware corporations are expected to act."[275] Moreover, because courts treat the Rule as creating an evidentiary presumption or as a standard of review, it does nothing to protect corporations (and their shareholders) from the reputational harms that accompany protracted litigation. The corporation is thus subjected to years of costly litigation, including a humiliating trial in which Disney's corporate governance practices were inspected under a microscope. The corporation has spent years embroiled in litigation that is expensive in attorneys' fees, resources, morale, and reputational harm, and the shareholders will not see any upside to all the *Sturm und Drang* to which the corporation is thereby subjected.

The Disney case highlights the disastrous consequences the deployment of the Rule can have in the context of shareholder challenges to executive pay. First, the problem nicely illustrates the ways in which executive compensation packages can include NFT

273. *In re Disney*, 907 A.2d at 697.

274. *Id.* at 701 (stating that the success of Ovitz's business "translated into an annual income of $20 million for Ovitz").

275. *Id.* at 763.

clauses that protect executives' generous severance packages in almost all circumstances.[276] Such clauses not only protect executives' interests; they protect boards from having to concede that they authorized generous salaries, retirement, and postretirement benefits to incompetent managers or to managers whose improprieties do not quite rise to the level of actionable fraud. The fact that no one at a corporation could work with an executive because they found him completely untrustworthy should be grounds for termination for cause, and a court should be permitted to investigate whether a board that approves a contract that does not permit for termination for cause in such circumstances should be held liable for negligence.

The Disney board's conduct in hiring Ovitz illustrates Bebchuk and Fried's argument about how one-sided the process of executive hiring can be.[277] Eisner and Ovitz had been friends for twenty-five years when Eisner recruited Ovitz for Disney.[278] Because Eisner's compensation package would have to be at least as generous as that of his subordinate, Eisner and the board he controlled had every reason to make Ovitz's compensation package as generous as possible. Eisner's personal lawyer, Russell,[279] negotiated on behalf of Disney, and Russell was paid $250,000 for his role in closing the deal with Ovitz.[280] He thus became invested in the transaction and would naturally be inclined to support it. Terms of Ovitz's compensation package were camouflaged to such an extent that even those who created them did not recognize the potential they entailed for creating perverse incentives.[281] In such circumstances, shareholders could not possibly have been reasonably well informed of the terms of Ovitz's compensation package. In the context of executive compensation, the Rule precludes a court from even considering whether structural bias on a board such as Disney's led directors to prioritize their own interests in the transaction and their own ties to Eisner and Ovitz over their duties to Disney and its shareholders.

The Disney case also illustrates why the Rule, conceived as an abstention doctrine designed to protect corporations from disclosure of confidential information relating to its prospective business plans,

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276. Bebchuk & Fried, *supra* note 126, at 812 (noting narrow definitions of "for cause" termination are now standard in executive employment contracts).

277. *See* BEBCHUK & FRIED, *supra* note 47, at 2.

278. *In re Disney*, 907 A.2d at 699.

279. *Id.* at 761 n.488.

280. Appellants' Opening Brief, *supra* note 62, at 11.

281. *See In re Disney*, 907 A.2d at 760 (stating that the board members were ordinarily negligent in the hiring of Ovitz and the approval of the OEA).

should have no application to cases involving challenges to executive compensation. While the decision to hire Ovitz might have been related to such prospective business plans, the contours of his compensation were determined with reference to standard pay packages for executives at other corporations and with reference to the pay for other Disney executives. Disney would suffer no irreparable harm from the disclosure of such information, and, of course, the information comes out anyway in litigation in which the Rule operates as a standard of review or as an evidentiary presumption.

The director-primacy model contends that the organizational efficiencies of the corporation better achieve the aim of shareholder wealth maximization through authority-based, decision-making processes than would a consensual shareholder-primacy model that permits shareholder action to trump board action.[282] Shareholder action is rare, as the director-primacy model acknowledges.[283] But shareholder action is rare because, in most circumstances, shareholders would rather switch than fight—recognizing that individual shareholders gain more from moving their money out of a poorly managed corporation and into a better one than from seeking to improve the management of a corporation in which they have invested through shareholder litigation.[284] On the rare occasions when shareholders are moved to challenge board action, absent a claim that the corporation will be damaged in the discovery process, a court should be permitted to determine when a board takes an action that is not in the interests of the corporation. The Ovitz transaction may or may not have been in the interests of Disney. The Rule prevents the Delaware courts from making any such determination, and, so deployed, the Rule impedes the adjudication of shareholder rights and interests, prevents shareholder actions from constraining boards, promotes board passivity, and thus permits negligent boards to cause economic harm to corporations and their shareholders.

Finally, as demonstrated in the Disney litigation, the Rule permits officers and directors to tread very delicately near the line that separates poor management from wasteful mismanagement and

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282. *See* Bainbridge, *supra* note 93, at 572 (touting the authority-based structure of the corporation as its "chief economic virtue"); Bainbridge, *supra* note 112, at 1654 (noting shareholder power undermines the purpose of authority-based, decision-making structures which achieve efficiency by concentrating discretionary authority in the board).

283. Bainbridge, *supra* note 93, at 557-58.

284. *See id.* (discussing shareholders' "rational apathy"); Romano, *supra* note 82, at 55 (noting the cost of bringing suit "is typically greater than a shareholder-plaintiff's pro rata benefit").

thereby nullifies any incentive they might have to perform better. In the case of decisions relating to executive pay, there is no reason why directors should not be liable for breaches of the duty of care under the generally applicable standard of care: "[T]he care an ordinarily prudent person in a like position would exercise under similar circumstances."[285] The purpose of imposing personal liability on directors for breaches of their duties of care and loyalty is to align their incentives with shareholders' interests.[286] To the extent the Rule interferes with the achievement of this goal, it undercuts the main thrust of reforms in corporate governance since the 1990s, which has sought further to align officers' and directors' incentives with those of shareholders.[287]

IV. CONCLUSION

The aim of this Article has been two-fold. First, the Article seeks to demonstrate existing rationales for the Rule are unsatisfactory and the two most common understandings of the Rule, the Rule as evidentiary presumption and the Rule as standard of review, lead courts to engage in substantive review of board decisions in circumstances where they really ought to abstain from any such review. Both of these problems regarding dominant understandings of the Rule derive from a tendency to view the Rule as a means of protecting the corporations' directors rather than as a mechanism for protecting corporations themselves from harms they might suffer through litigation.

Second, the Article proposes a new rationale for the Rule: the Rule ought to be deployed as an abstention doctrine to preclude a court from undertaking substantive review of a board's decisions when challenges to those decisions would require the corporation to disclose its prospective business plans. The Article suggests the Rule would thus often apply in the context of decisions relating to acquisitions and mergers and to the issuance of dividends, but it would rarely apply in the context of shareholder challenges to decisions relating to executive compensation. As illustrated in the recent litigation relating to Disney's hiring and firing of Ovitz, such decisions do not implicate any long-term plans of the corporation, and the corporation is not

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285. MODEL BUS. CORP. ACT § 8.30 (1998).

286. Romano, *supra* note 82, at 55.

287. *See* KHURANA, *supra* note 136, at xiv (arguing investor capitalism has superseded managerial capitalism and yet still faulting the search for executives as valuing charisma over competence); Bainbridge, *supra* note 93, at 562-63 (arguing the recent trend of compensating directors with stock has better aligned directors' interests with those of shareholders).

harmed any more by a full inquiry into the propriety of decisions relating to executive compensation than it is by an inquiry limited by the dictates of the Rule when it is treated as either a presumption or a standard of review. The Rule should not be at play in executive compensation cases and other contexts in which the discovery process does not threaten to compel disclosure of prospective business plans, because, in such contexts, the Rule frustrates the purpose underlying shareholder litigation: holding directors to account for their failure to perform their fiduciary duties in a manner consistent with shareholder interests.