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## Executive Compensation and the Optimal Penumbra of Delaware Corporate Law

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## EXECUTIVE COMPENSATION AND THE OPTIMAL PENUMBRA OF DELAWARE CORPORATION LAW

Claire Hill<sup>†</sup> and Brett McDonnell<sup>††</sup>

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### ABSTRACT

Corporate law has done a very poor job on executive pay: executives have been rewarded for stellar “performance” that turned out to be anything but stellar, and shareholders have had no meaningful recourse. Indeed, there are many other such cases where there is no breach of the fiduciary duties of care and loyalty, but the board’s behavior nevertheless smacks of a classic agency problem known as structural bias.

We argue that law on the books and as enforced is not well situated to deal with structural bias. What does show some promise, however, is the marshalling of extra-legal forces that effectively extend Delaware corporate law, constituting a penumbra. Corporate directors’ behavior is very much influenced by what is in the penumbra.

The Delaware judiciary’s participation in the corporate law debate in fora other than the courtroom significantly shapes the penumbra. Law firm memos to clients play an important role too, conveying both the court holdings and the dicta as advice to clients. The penumbra also includes the many voices participating in the corporate governance debate through shareholder proposals, court cases brought about shareholder proposals, and the views of corporate governance activists. While the penumbra is not an unambiguous good—certainly, actors with problematic self-interests may be among those helping shape it—it does provide an important counterweight to the directors’ ability to prefer their own interests over those of their principals, the corporation and its shareholders.

### INTRODUCTION

*“Harkey’s fellow [Special Committee] member, Simon, brought the scientific concept of inertia to the Special Committee by generally remaining at rest until set into motion by the Committee’s advisors.”*<sup>1</sup>

**E**XECUTIVE compensation is much in the news. Executives in the last few years, especially those in financial service companies, have received enormous salaries and bonuses to reward them for what appeared to be stellar performance. But appearances were deceiving: We now see that, certainly for

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1. *In re Loral Space & Commc'ns, Inc. Consol. Litig.*, Nos. 2808–VCS, 3022–VCS, 2008 WL 4293781, at \*22 (Del. Ch. Sept. 19, 2008) (Strine, V.C.) (criticizing defendant directors for the procedure they used in considering a related party transaction).

financial service companies, and apparently for many other companies as well, the “performance” was part of an unsustainable bubble. Enormous losses have followed—enough to wipe out the supposed gains, and then some—but executives have not been required to return their pay.

We, along with many other commentators, believe that corporate law has done a very poor job with executive pay, as well as with other manifestations of structural bias.<sup>2</sup> First, directors of a corporation may be beholden to the corporation’s officers for their jobs. Second, they may abide by a “pernicious golden rule” under which they defer to the officers as they would have directors defer to them in their capacities as officers of other corporations. Third, directors may simply see the world from the same vantage point as the officers do, a vantage point from which the executive compensation packages we have seen are reasonable and appropriate. The result, too often, is that directors rubber-stamp decisions, rather than give them proper consideration.

In this Article, we will show how extra-legal forces, particularly non-binding pronouncements of the Delaware judiciary, are a critical adjunct to corporate law, particularly in the area of structural bias. We argued in previous works that the emerging corporate law on good faith, within the broader duty of loyalty, might play an important role.<sup>3</sup> Delaware courts, however, seem to be severely limiting the scope of that doctrine.<sup>4</sup> Thus, extra-legal forces will need to play an increasingly important role.

These extra-legal forces constitute a penumbra that extends Delaware corporate law significantly beyond law on the books as enforced—a penumbra that very much influences how corporate directors conduct

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2. The term “structural bias” is used in corporate law cases to refer to excessive deference by the directors to the management because of interlocking relationships or because they travel in the same social and economic circles. *See, e.g.*, *Beam v. Stewart*, 845 A.2d 1040, 1050–51 (Del. 2004); *Aronson v. Lewis*, 473 A.2d 805, 815 n.8 (Del. 1984). In our article, Claire A. Hill & Brett H. McDonnell, *Stone v. Ritter and the Expanding Duty of Loyalty*, 76 *FORDHAM L. REV.* 1769 (2007), we defined “structural bias,” roughly, as “excessive deference to the other directors or officers.” *Id.* at 1780. In that article, we distinguished “suspect motive” cases as “cases where director or officer self-interest may be present but the actions at issue involve core corporate concerns, and hence are appropriately not scrutinized to the same extent as cases implicating the traditional duty of loyalty.” *Id.* For purposes of our thesis in this Article, however, both types of cases can be treated under the general rubric of “structural bias.” We are arguing for scrutiny-by-shaming, not scrutiny as a technical legal matter; both types of cases can benefit equally from the former type of scrutiny.
  3. Hill & McDonnell, *supra* note 2, at 1770; Claire A. Hill & Brett H. McDonnell, *Disney, Good Faith, and Structural Bias*, 32 *J. CORP. L.* 833, 855–56 (2007).
  4. *See, e.g.*, *Lyondell Chem. Co. v. Ryan*, 970 A.2d 235, 243–44 (Del. 2009).

themselves. The penumbra is importantly influenced by the Delaware corporate judiciary's participation in the corporate law debate in fora other than the courtroom. Law firm memos and verbal advice to clients play an important role too, conveying both the court holdings and the dicta as advice to clients. The penumbra also includes the many voices participating in the corporate governance debate through shareholder proposals, court cases regarding shareholder proposals, and the otherwise-expressed views of corporate governance activists.

In this Article, we will discuss why law on the books and as enforced cannot properly deal with structural bias. A crucial task for contemporary corporate governance is to prepare and incentivize directors to be vigorous and intelligent monitors of corporate management, without creating such risk of legal liability that no one wants to be a director. The latter consideration leads corporate law, as developed in statutes and enforced in court decisions, to be largely rule-based. But corporate actors are very well situated to craft legalistic modes of compliance that honor the fact but gut the spirit of the rules. Consider the process established post-*Van Gorkom* for reviewing mergers proposed by management, characterized by many as a full employment act for investment bankers and lawyers at the expense of the corporation and its shareholders.<sup>5</sup> Thus, standard-like “you know it when you see it” considerations should inform how corporate actors’ conduct is regulated. But how are the standards established, and what gives them force without creating too much risk of liability? The penumbra of corporate law. We fully recognize that the processes that constrain law may not be so successful at constraining its penumbra—a justified source of concern, given that extra-legal forces may not always operate for the good. Still, we think that on balance, a more expansive penumbra of the sort we presently have is preferable to a less expansive penumbra. For example, consider the effect the introductory quote is likely to have on the composition and behavior of special committees. The penumbra serves as a needed counterweight to structurally-biased boards—something that influences directors to advance the interests of the corporation.

Our conclusion is nicely illustrated by the debate on executive pay. Law thus far has been ineffectual at reigning in outsized pay packages, most notably those that purport (not altogether accurately) to be sensitive to performance. Certainly, the process in place, according a prominent role to nominally independent directors, does not do much to help. Independence in

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5. See Hill & McDonnell, *supra* note 2, at 1772 n.14.

mindset is clearly different from independence as defined under the securities law or the rules of stock exchanges.<sup>6</sup> Just as importantly, it is not possible to craft, much less mandate, bright line, non-gameable rules or procedures by which compensation can be determined. What we really want is hard to specify except by reference to what would be awarded by well-informed businesspeople not influenced by cronyism or the pernicious golden rule. We think that in this area, the marshalling of extra-legal forces is showing increasing promise. As more officers voluntarily relinquish their bonuses and tie their pay more closely to true performance, pressure will grow for others to do so.<sup>7</sup> Delaware judges have weighed in on the issue before, and may very well do so again. Activist initiatives on the subject have increased as well. The penumbra may do what law thus far has not been able to do: bring executive compensation back down to earth and tie it far more successfully to performance.

This Article proceeds as follows. Part I outlines some major background elements: the basic legal structure of Delaware fiduciary duty law and the historical growth of the monitoring board model. Part II analyzes how Delaware law falls short and why it therefore needs a penumbra. We want to encourage a critical mindset among directors, but cannot readily do so by imposing outright legal liability for uncritical toadying. Extra-legal forces offer a way to complement and enhance the force of law. Part III discusses what others have said about the penumbra. Part IV characterizes the penumbra itself and how it works to translate pronouncements from Delaware judges into pressure on directors to show more backbone. Part V considers the “dark side” of the penumbra: problems created when the penumbra empowers voices we may not want to empower. Part VI applies

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6. See Securities Exchange Act of 1934 § 10A(m)(3) (codified as amended at 15 U.S.C. § 78j-1(m)(3) (2006)); NYSE, Inc., Listed Company Manual § 303A.02 (2009), available at [http://nysemanual.nyse.com/1.CMTTools/PlatformViewer.asp?selectednode=chp\\_1\\_4\\_&manual=%2Ffcm%2Fsections%2Ffcm-sections%2F](http://nysemanual.nyse.com/1.CMTTools/PlatformViewer.asp?selectednode=chp_1_4_&manual=%2Ffcm%2Fsections%2Ffcm-sections%2F). The definition of “independence” in Delaware case law comes much closer to what we would like to see. See *infra* notes 56–58 and accompanying text.
  7. When AIG’s bonuses were announced, the recipients faced death threats, and many chose to return their bonuses. See Tom Baldwin & Christine Seib, *Armed Guards at AIG Offices After Death Threats Over Bonuses*, *TIMES* (London), Mar. 18, 2009, at 42, available at [http://business.timesonline.co.uk/tol/business/industry\\_sectors/banking\\_and\\_finance/article5927610.ece](http://business.timesonline.co.uk/tol/business/industry_sectors/banking_and_finance/article5927610.ece); Karen Freifeld, *Cuomo Says Half of AIG’s Bonus Money May Be Returned*, *BLOOMBERG*, Mar. 23, 2009, <http://www.bloomberg.com/apps/news?pid=20601103&sid=autaU6Zhd3ms>. Returning bonuses in this context would not fall into the category of “voluntary” relinquishment. General outrage over bonuses, however, is arguably part of the penumbra we are discussing.

the analysis to the important case of executive compensation. Our Conclusion follows.

## I. BETWEEN CARE AND LOYALTY

Delaware law traditionally recognized two fiduciary duties: the duty of care and the duty of loyalty. It became clear, however, that these two duties as classically formulated were not enough—that board conduct needed to be constrained in ways that were not reached by those two duties. Recent cases have given prominence to a new duty, now characterized as part of the duty of loyalty: the duty of good faith. The duty of good faith has become increasingly important over the last several decades as a means to address behavior that does not violate fiduciary duties as traditionally articulated, but that is nevertheless harmful to the corporation and its shareholders.<sup>8</sup> This doctrinal development, in turn, has occurred because of, and has helped to promote, the growth of the monitoring model of boards of public corporations. In this Part, we describe and analyze the doctrinal development of the duty of good faith; we also discuss the economic and social development of the monitoring board.

Traditionally, fiduciary duty analysis in corporate law had two quite different branches. The duty of loyalty applied where a director, officer, or controlling shareholder had a financial conflict of interest that was material enough that it could be expected to significantly influence her decision, creating a serious risk that this personal interest would cause her to make a decision that was not in the best interests of the corporation.<sup>9</sup> A prototypical example is a director selling property to, or buying property from, the corporation.

Where a conflict of interest exists, courts will scrutinize the relevant corporate decision closely. The defendants will need to show that a conflicted transaction was nonetheless justified. They can do so in one of three ways.<sup>10</sup> First, the defendants may try to show that disinterested and independent directors approved the transaction. If they attempt to make such a showing, courts will look somewhat closely at whether the directors

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8. For our purposes, we do not need to resolve the difficult question of whether fiduciary duties are owed “to the corporation” or “to shareholders.”

9. See *Rales v. Blasband*, 634 A.2d 927, 936 (Del. 1993).

10. See DEL. CODE ANN. tit. 8, § 144 (2009). We discuss Delaware’s approach to conflicted transactions in Hill & McDonnell, *Disney, Good Faith, and Structural Bias*, *supra* note 3, at 835–36.

were in fact disinterested and independent, particularly where there is a controlling shareholder, and whether those directors exercised sound business judgment in approving the transaction.<sup>11</sup> Second, the defendants may try to show that a majority of the disinterested shareholders approved the transaction. Here, courts will look somewhat closely to affirm that the shareholders were disinterested and that they were informed of all material facts before approving the transaction.<sup>12</sup> Third, the defendants may try to show that the transaction was entirely fair to the corporation. This involves showing both that the transaction was substantively fair and also that the procedure followed in approving the transaction was fair.<sup>13</sup>

Many have argued that this framework makes it too easy to justify conflicted transactions.<sup>14</sup> Yet once a plaintiff has succeeded in showing that a conflict of interest exists and hence that the duty of loyalty applies, at least the plaintiff has a fighting chance. There is a non-negligible chance that the court will decide that the transaction is not justified and either award damages or enjoin the transaction. Corporate boards faced with a conflicted transaction are well advised to closely follow the prescribed procedures in the case law for achieving valid board or shareholder approval, because if they do not, they face a serious chance that their directors will be held liable in court.

By contrast, analysis as to whether directors have violated their duty of care is dominated by the business judgment rule, which affords considerable deference to directors. The court presumes that “in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.”<sup>15</sup> Traditionally, it has been extremely difficult for plaintiffs to overcome this presumption. Indeed, when the Delaware Supreme Court actually dared to hold defendants liable in what was labeled a duty of care case, *Smith v. Van Gorkom*,<sup>16</sup> a shockwave swept over the world of corporate governance. Director and officer insurance premia skyrocketed, boards faced challenges recruiting directors, and the Delaware legislature quickly responded with Delaware General Corporation Law (“DGCL”) section 102(b)(7), which

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11. See *Kahn v. Lynch Commc'n Sys.*, 669 A.2d 79, 82–83 (Del. 1995).

12. See *In re Wheelabrator Techs., Inc. S'holders Litig.*, 663 A.2d 1194, 1205 (Del. Ch. 1995).

13. See *Weinberger v. UOP, Inc.*, 457 A.2d 701, 711 (Del. 1983).

14. See, e.g., Lawrence L. Mitchell, *Fairness and Trust in Corporate Law*, 43 *DUKE L.J.* 425, 491 (1993).

15. *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984).

16. 488 A.2d 858, 893 (Del. 1985).



shields directors from personal liability for good faith violations of the duty of care.<sup>17</sup>

Thus, in traditional fiduciary duty analysis, the key determination was whether the challenged transaction involved a conflict of interest. If it did, the duty of loyalty applied, and there was at least a decent chance that the plaintiff could prevail and the defendant could be held personally liable. If there was no conflict of interest, the duty of care applied, and both the business judgment rule and DGCL section 102(b)(7) (or its equivalent in other states) made a plaintiff victory, and particularly personal liability for directors, extremely unlikely.

Those were the two alternative modes of analysis. That is the way it was portrayed in the casebooks. The structures of the Model Business Corporation Act<sup>18</sup> and the ALI Principles of Governance<sup>19</sup> both reflected these two main branches. That is the way we taught our students corporate law.

But things have gotten more complicated over the last couple of decades. The biggest complications occurred in the area of corporate changes of control—friendly and hostile takeovers. Intermediate standards that did not neatly fit within either traditional loyalty or care began to appear. The *Unocal* standard applied where boards took actions to defend against potential unwanted changes of control.<sup>20</sup> The *Revlon* standard applied where boards initiated certain types of sale of control.<sup>21</sup>

Other intermediate standards of review emerged in other contexts as well. The *Zapata* standard applied where a special litigation committee recommended dismissing a shareholder derivative suit in a case where the demand requirement was excused.<sup>22</sup> The *Blasius* standard applied to board actions taken with the primary purpose of frustrating the shareholder franchise.<sup>23</sup>

More recently, the Delaware courts began systematically developing the good faith doctrine. Action that is in bad faith is not protected by the

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17. DEL. CODE ANN. tit. 8, § 102(b)(7) (2009).

18. MODEL BUS. CORP. ACT ch. 8, subchs. C, F (2002).

19. AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS Parts IV & V (1994).

20. *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 955 (Del. 1985).

21. *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 182 (Del. 1986).

22. *Zapata Corp. v. Maldonado*, 430 A.2d 779, 787–88 (Del. 1981).

23. *Blasius Indus., Inc. v. Atlas Corp.*, 564 A.2d 651, 661–62 (Del. Ch. 1988).

business judgment rule, nor can director liability be waived under DGCL section 102(b)(7) for bad faith action. Because of these rules, plaintiffs started making claims that board actions were in bad faith, and the Delaware courts had to begin adjudicating those claims. Three of the leading cases so far have been *Caremark*,<sup>24</sup> *Disney*,<sup>25</sup> and *Stone v. Ritter*.<sup>26</sup>

With *Caremark*, the Delaware Court of Chancery decided that the board has a duty to monitor the behavior of the corporation's employees to guard against illegal behavior. The court left the board great leeway in deciding how to carry out this duty, but boards cannot choose not to monitor at all. It is hard for plaintiffs to prevail in a *Caremark*-type case: As the court put it, "only a sustained or systematic failure of the board to exercise oversight—such as an utter failure to attempt to assure a reasonable information and reporting system exists [sic]—will establish the lack of good faith that is a necessary condition to liability."<sup>27</sup> But plaintiff success is possible.

In *Stone v. Ritter*, the Delaware Supreme Court confirmed that the *Caremark* duty was indeed good law in Delaware, the first time that the court had opined on the subject.<sup>28</sup> More importantly and controversially, the court declared that the requirement to act in good faith was a subset of the duty of loyalty, not an independent duty (and not a component of the duty of care).<sup>29</sup> Some commentators have questioned this holding;<sup>30</sup> we defended it in our previous article.<sup>31</sup>

The *Disney* cases provide the most systematic discussion yet of what constitutes behavior not in good faith. The cases concerned the compensation received by Disney second-in-command Michael Ovitz, and whether the board violated its fiduciary duty in designing Ovitz's contract or in allowing him to exit the company with a huge windfall after only a year on the job—a year in which he performed quite poorly. The Chancery and Supreme Courts developed the following general formulation:

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24. *In re Caremark Int'l, Inc. Deriv. Litig.*, 698 A.2d 959 (Del. Ch. 1996).

25. There were a number of decisions in this long-lasting litigation. The final Delaware Supreme Court decision was *In re The Walt Disney Co. Deriv. Litig.*, 906 A.2d 27 (Del. 2006).

26. 911 A.2d 362 (Del. 2006).

27. *In re Caremark*, 698 A.2d at 971.

28. *Stone*, 911 A.2d at 365.

29. *Id.* at 370.

30. See, e.g., Stephen M. Bainbridge et al., *The Convergence of Good Faith and Oversight*, 55 UCL.A L. REV. 559, 604 (2008).

31. Hill & McDonnell, *supra* note 2, at 1770.

A failure to act in good faith may be shown, for instance, where the fiduciary intentionally acts with a purpose other than that of advancing the best interests of the corporation, where the fiduciary acts with the intent to violate applicable positive law, or where the fiduciary intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties. There may be other examples of bad faith yet to be proven or alleged, but these three are the most salient.<sup>32</sup>

What the Delaware judiciary—both the Chancery Court and the Supreme Court—had to say in *Disney* might make the good faith doctrine seem quite promising as a means to address structural bias. That being said, while “good faith,” even narrowly construed, is a helpful adjunct to problematic director behavior that does not implicate the duty of loyalty as traditionally construed, it does not have nearly the reach it needs to fully address structural bias. The problem is in the doctrine’s emphasis on intentional avoidance or conscious disregard of duty. Is a director who is influenced by the factors discussed above—similarity in mindset and adherence (whether consciously or not) to the pernicious golden rule—acting with a “conscious disregard” to his duties? Probably not. Yet, in some cases such behavior may, at the earlier stages of a case, look enough like conscious disregard that plaintiffs are able to survive a motion to dismiss. This happened in the first *Disney* decision, allowing the case to move forward.<sup>33</sup> It appeared to be happening in a current sale of control case involving *Revlon* claims, *Ryan v. Lyondell Chemical Co.*,<sup>34</sup> until the Delaware Supreme Court reversed, holding that “[o]nly if [directors] knowingly and completely failed to undertake their responsibilities would they breach their duty of loyalty.”<sup>35</sup> It remains to be seen how the case law will develop, but a recent article co-authored by Vice Chancellor Strine of the Delaware Chancery Court and several leading lawyers of the Delaware bar suggests that at least some prominent voices endorse the narrower standard rather than the more expansive standard that *Disney* might have

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32. *In re The Walt Disney Co. Deriv. Litig.*, 906 A.2d 27, 67 (2006) (quoting *In re The Walt Disney Co. Deriv. Litig.*, 907 A.2d 693, 755–56 (2005)).

33. *In re The Walt Disney Co. Deriv. Litig.*, 825 A.2d 275, 278, 286–87 (Del. Ch. 2003).

34. *Ryan v. Lyondell Chem. Co.*, No. 3176–VCN, 2008 WL 2923427, at \*18 (Del. Ch. July 29, 2008), *rev’d sub nom.*, *Lyondell Chem. Co. v. Ryan*, 970 A.2d 235 (Del. 2009).

35. *Lyondell Chem. Co. v. Ryan*, 970 A.2d 235, 243–44 (Del. 2009).

accommodated.<sup>36</sup> The Supreme Court decision in *Lyondell* certainly supports that prediction.<sup>37</sup>

Whether good faith is interpreted narrowly or more expansively, it clearly stands between the traditional duty of loyalty and the duty of care. In our previous articles, we have argued that good faith, together with the other intermediate standards, yields a continuum of judicial scrutiny between traditional loyalty and care.<sup>38</sup> In some circumstances, such as in *Caremark*, courts scrutinize board behavior little more than they would under the duty of care. In other circumstances, such as in *Blasius*, the judicial scrutiny is nearly as strict as under traditional loyalty analysis.<sup>39</sup>

Why did this explosion of intermediate standards of fiduciary duty occur over the last few decades? It is tied to a fundamental change in the role of the board. From the beginning of modern corporate law, the board of directors has been nominally in charge of the corporation. All legal authority within a corporation resides in, and flows from, its board. Shareholders are granted very few powers, other than electing the board itself. Although the board may, and in public corporations does, delegate its power to officers who actually run the company, the original power to make almost all corporate decisions has always resided in the board, with the power exercised by officers and managers being legally derived from the board's authority.<sup>40</sup>

However, for most of the history of the modern public corporation, the reality has been otherwise. Corporations were dominated either by a founder or controlling shareholder, or, later in the life of successful public corporations, by their top officers. The controlling shareholder or top

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36. Leo E. Strinc, Jr. et al., *Loyalty's Core Demand: The Defining Role of Good Faith in Corporation Law*, GEO. L.J. (forthcoming 2009), available at [http://works.bepress.com/lawrence\\_hamermesh/36/](http://works.bepress.com/lawrence_hamermesh/36/).

37. In a new paper, Julian Velasco argues that good faith and what he calls bias or reasonableness are actually two different paradigms of review standards. Julian Velasco, *How Many Fiduciary Duties Are There in Corporate Law?* 3–4, 11–17 (Notre Dame Legal Studies, Paper No. 09–35, 2009), available at <http://ssrn.com/abstract=1457804>. In the past we have combined the two, and we think that older language, in cases like *Unocal* and *Zapata*, very much allow for a more expansive understanding of good faith. However, the most recent cases do seem to be narrowing considerably the understanding of good faith in Delaware courts.

38. Hill & McDonnell, *supra* note 2, at 1779–87; Hill & McDonnell, Disney, *Good Faith, and Structural Bias*, *supra* note 3, at 850–54.

39. A recent case suggests that scrutiny afforded to *Blasius*-type cases may be lessening. See *Mercier v. Inter-Tel (Del.), Inc.*, 929 A.2d 786 (Del. Ch. 2007).

40. See STEPHEN M. BAINBRIDGE, *THE NEW CORPORATE GOVERNANCE IN THEORY AND PRACTICE* 11–12 (2008).

officers effectively had control over who was elected to the board, with the predictable result of boards dominated by cronies and yes-men who did not challenge the decisions of the controlling persons.

In traditional studies of corporate governance, the board of directors played a very limited role. For instance, Berle and Means, in the first modern scholarly analysis of large public corporations and the separation between ownership and control, focused mostly on top corporate managers and officers, and not particularly on the role of directors.<sup>41</sup> Similarly, the leading history of the growth of large American corporations is that of Alfred Chandler. Yet Chandler devotes almost no attention to the role of boards.<sup>42</sup>

The composition and function of boards used to be quite different from what we see in the United States today. Historically, a much higher proportion of the board was composed of inside officers or closely-connected outsiders with crucial ties to the management, such as outside counsel and investment bankers. The main function of the board was to provide advice to the company's officers on major strategic decisions. A second important function was often to help attract significant resources to the corporation. A third function, monitoring the actions of corporate managers, was present but much less important than it has become today.

Thus, for much of the twentieth century, the leading theory of corporate behavior was managerialism.<sup>43</sup> The corporation was understood to be dominated by its managers. There was much debate over what objectives those managers did and should have, and over how to align their actual objectives with the desired objectives. The board of directors was basically an afterthought.

All that has changed in major ways over the last few decades. A series of practical and legal reforms has strived to put into place a new model of the board that focuses on its role as a monitor of top management. These reforms came about in part because of widespread criticism of the managerialist model. Since at least Berle and Means, critics of large corporations had focused on the principal-agent problem inherent in the corporate form.<sup>44</sup> Managers, it was argued, did not have proper incentives to

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41. ADOLF A. BERLE, JR. & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (1932).

42. ALFRED D. CHANDLER, JR., *THE VISIBLE HAND: THE MANAGERIAL REVOLUTION IN AMERICAN BUSINESS* (1977).

43. ROBIN MARRIS, *THE ECONOMIC THEORY OF 'MANAGERIAL' CAPITALISM* (1964).

44. See BERLE & MEANS, *supra* note 41. The seminal modern work is Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership*

aggressively pursue the interests of the corporation and its shareholders. Their compensation was largely inflexible, not sensitive to good or bad corporate performance. No one had the ability and the incentive to monitor the managers. Large companies had enough cash and little enough competition that their managers did not need to greatly fear the consequences of failing to fervently promote the interests of the corporation.

As part of the new reforms, the composition of boards changed, with a growing fraction of directors required to be independent, without significant ties to the company aside from their roles as directors. Stock exchanges<sup>45</sup> and federal securities law<sup>46</sup> now require a majority of independent directors either on the board itself or on certain critical board committees. State law does not require independent directors, but a corporate decision will typically receive significantly less judicial scrutiny if the defendants can convince the court that the directors making the decision were independent as defined by the applicable regulations or as determined by a court.<sup>47</sup>

Hostile takeovers, leveraged buyouts, and management buyouts were also part of the new corporate governance. Hostile takeovers replaced incompetent or poorly-motivated managers, and the fear of such takeovers provided needed motivation.<sup>48</sup> Buyouts created leaner organizations, and their debt load forced managers to achieve results or face their creditors.<sup>49</sup> However, this new market for corporate control created new opportunities and temptations for incumbent managers as well. Incumbents could fend off hostile takeovers by using the ingenious forms of anti-takeover defenses that came into being. LBOs presented chances for insiders to enrich themselves. Boards played a growing role in responding to and shaping these forces.<sup>50</sup>

New forms of executive compensation were also a big part of the new corporate governance. Tying managerial compensation to corporate

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- Structure*, 3 J. FIN. ECON. 305 (1976). Variants of the critique go back much further, at least to Adam Smith. See ADAM SMITH, AN INQUIRY INTO NATURE AND CAUSES OF THE WEALTH OF NATIONS (Edwin Cannan, ed., Methuen 1904) (1776).
45. See e.g., NYSE, Inc., Listed Company Manual, § 303A.01 (2009), available at [http://nysemanual.nysc.com/LCMTtools/bookmark.asp?id=sx-ruling-nyse-policymanual\\_303A.00&manual=/lcm/sections/lcm-sections/](http://nysemanual.nysc.com/LCMTtools/bookmark.asp?id=sx-ruling-nyse-policymanual_303A.00&manual=/lcm/sections/lcm-sections/).
46. Securities Exchange Act of 1934 § 10A(m) (codified as amended at 15 U.S.C. § 78j-1(m) (2006)).
47. See, e.g., *Marciano v. Nakash*, 535 A.2d 400, 405 (Del. 1987); *Kahn v. Lynch Comm'n Sys., Inc.*, 669 A.2d 79, 80 (Del. 1995).
48. See Henry G. Mann, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110, 113 (1965).
49. See Michael C. Jensen, *Eclipse of the Public Corporation*, 67 HARV. BUS. REV. 61 (1989).
50. The leading case in response to these developments was *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985).

performance, often measured by the stock price, it was argued, would give stronger incentives to pursue the corporation's interests.<sup>51</sup> Yet here, too, new temptations arose, as executives found ways to use the new forms of compensation to vastly increase their pay while still reducing the downside risk to themselves if their corporation did not perform well.<sup>52</sup> Here, too the importance of the board grew, as boards were responsible for devising and overseeing executive compensation.

A growing number of activist shareholders and corporate watchdogs have focused on the behavior of boards. Activists have created formal measures of corporate governance that measure the extent to which boards have formally shielded themselves from shareholder disapproval.<sup>53</sup> Activists scrutinize the composition of boards for signs of directors who fit formal definitions of independence but, in fact, are cronies of the CEO. Where executive compensation gets egregiously excessive, especially if the company's performance has been poor, shareholders question directors, and directors start asking closer questions of executives.

The demands of the job of director have increased notably. The job takes more time than it used to—boards meet more frequently, and their meetings last longer. There are more committees, and those committees, like the full boards, meet more frequently in longer meetings than before. Directors are expected to do more thorough homework before a meeting than used to be the case, reading a large packet of material before each meeting. Directors are expected to be active participants in meetings, asking probing questions and not settling for evasive answers.<sup>54</sup>

Notwithstanding the new emphasis on the task of monitoring, and the need for director independence to perform this task, cronyism and insider domination of boards are still quite common. Formal independence often does not mean real independence in practice. Indeed, ultimately what is wanted is a critical mindset: directors with the ability and inclination to critically review the decisions of managers, and the willingness to say 'no' if warranted. This critical mindset is hard to measure or prescribe, and correlates only very weakly with new formal definitions of director

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51. See Michael C. Jensen & Kevin J. Murphy, *Performance Pay and Top-Management Incentives*, 98 J. POL. ECON. 225, 226 (1990).

52. See generally LUCIAN BEBCHUK & JESSE FRIED, *PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION* (2004).

53. See, e.g., RiskMetrics Group, 2009 Board Practices, <http://riskmetrics.com/knowledge/2009bp> (last visited Sept. 13, 2009).

54. BAINBRIDGE, *supra* note 40, at 199–200.

independence.<sup>55</sup> It fits better with the more standard-like, contextual definition of independence in Delaware law.<sup>56</sup> Occasionally Delaware courts apply this definition aggressively,<sup>57</sup> although more often they do not, finding boards to be independent when common sense might suggest otherwise.<sup>58</sup>

Present-day boards' longer meetings may often mean more time with various paid experts going over recommended checklists. The large packets of material provided to directors may not be as closely read as they should be, and may not be truly revealing of the state of the corporation even when read closely. Outside directors have less access to information than insiders, and hence may be less able to ask truly probing questions. The extensive literature on formally independent boards has not resolved the question of whether they lead to improvements in corporate performance; certainly, early hopes and expectations that board independence would be an unmitigated good have not been borne out.<sup>59</sup>

We think the changes are real, even if still highly incomplete and of disputable value. Obviously, some companies have gone much further than others in achieving real board independence, and behavior varies enormously among directors. Still, there have been real changes in board composition and behavior, and in the expectations that the major corporate actors have of the board's role. Boards are now at the center of discussions of corporate governance, both its reality and the possibilities for its reform.

The growth of the case law discussed at the beginning of this Part is closely and complicatedly tied to the growth of the monitoring model of the board. The case law both reflects that new role and has also helped to define and promote it. In the cases, courts will often point to existing best practices and either praise boards for following those practices or scold them for failing

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55. Claire A. Hill & Erin Ann O'Hara, *A Cognitive Theory of Trust*, 84 WASH U. L.R. 1717, 1781–85 (2007).

56. "The primary basis upon which a director's independence must be measured is whether the director's decision is based on the corporate merits of the subject before the board, rather than extraneous considerations or influences." *Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart*, 845 A.2d 1040, 1049 (Del. 2004). For more discussion on this point, see Hill & McDonnell, *Disney, Good Faith, and Structural Bias*, *supra* note 3, at nn.137–39 and accompanying text.

57. *See, e.g., In re Oracle Corp. Deriv. Litig.*, 824 A.2d 917, 937–48 (Del. Ch. 2003).

58. *See, e.g., Stewart*, 845 A.2d at 1051–55; *In re Walt Disney Co. Deriv. Litig.*, 731 A.2d 342, 354–57 (Del. Ch. 1998), *aff'd in part, rev'd in part sub nom., Brehm v. Eisner*, 746 A.2d 244 (Del. 2000).

59. *See, e.g., Sanjai Bhagat & Bernard Black, The Non-Correlation Between Board Independence and Long-Term Firm Performance*, 27 J. CORP. L. 231, 234–37 (2002).



to do so. Thus, existing practice influences the law, and the cases help publicize, extol, and encourage existing best practices.

Delaware case law has helped bring this monitoring model of the board into being.<sup>60</sup> The old, simple two-branch model made a good deal of sense in the days of weak boards which focused mainly on providing strategic advice. Being in a position of formal power within a large public corporation necessarily may provide temptations to steal resources from the company, and courts can help by policing out-and-out theft. The traditional duty of loyalty did that. Beyond avoiding theft, directors were not expected to do much besides give advice. Where a decision did not involve a material conflict of interest, it did not present a strong temptation to go against the interests of shareholders. There was, of course, some temptation to not work very hard—even less hard than was traditionally expected of directors—but there was not a lot the law could effectively do about that, as was recognized with the weak duty of care and the business judgment rule.

The growth of the monitoring model of the board has complicated matters for directors. They are now expected to closely monitor the actions of corporate officers and ensure that they are effectively pursuing the interests of the corporation. There are good reasons to believe directors may not be fully inclined to carry out these new duties. For one, boards are typically self-reproducing, with shareholders rarely having a say in who the nominees are.<sup>61</sup> The natural tendency has been for the CEO to dominate the process, resulting in directors who are highly sympathetic to the top officers. A different problem is what we have called the pernicious golden rule. Board directors themselves are often senior officers in other corporations. They therefore naturally tend to prefer practices which favor senior corporate officers.<sup>62</sup> For some set of decisions the board makes, self-interest is more directly at stake, as those decisions affect who will be in control of future boards and hence the likelihood of current directors retaining their

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60. BAINBRIDGE, *supra* note 40, at 172–76.

61. Hill & McDonnell, Disney, *Good Faith, and Structural Bias*, *supra* note 3, at 853. If some version of the SEC's current proxy access proposal eventually passes, this will give shareholders more ability to nominate director candidates. Facilitating Shareholder Director Nominations, Securities Act Release No. 33-9046, 74 Fed. Reg. 29,024 (proposed June 10, 2009), available at <http://www.sec.gov/rules/proposed/2009/33-9046.pdf>.

62. Hill & McDonnell, Disney, *Good Faith, and Structural Bias*, *supra* note 3, at 853; see also Jones v. Harris Assocs., L.P., 537 F.3d 728, 730 (7th Cir. 2008) (Posner, J., dissenting from denial of rehearing en banc) (“Directors are often CEOs of other companies and naturally think that CEOs should be well paid. And often they are picked by the CEO.”).

positions.<sup>63</sup> The term commonly used by the courts and commentators to describe these factors is “structural bias.”<sup>64</sup>

When it was not an important function of boards to monitor, structural bias was not particularly harmful. The harm arises because structural bias is, by its nature, antithetical to monitoring. The bias is in favor of the officers—precisely those who are supposed to be critically monitored. In our earlier articles we considered structural bias and showed how the factual circumstances typically surrounding good faith cases and various forms of intermediate scrutiny all tend to involve at least some degree of structural bias.<sup>65</sup> Thus, the growth of cases applying intermediate scrutiny—higher scrutiny than that applied in care cases, but lower than that applied in traditional loyalty cases—addresses the structural bias problems that have become more objectionable with the growth of the monitoring board.

## II. WHY A PENUMBRA IS NEEDED

The traditional fiduciary duties capture and seek to address the obvious ways agents might misbehave. An agent might take less care and attention as to her principal’s business than she would as to her own business. An agent might help herself to her principal’s property, or use information about the principal to personally compete. Thus, we have the duty of care and the duty of loyalty. The courts are anxious not to micromanage corporations; where there is no taint arising from a loyalty conflict,<sup>66</sup> the doctrine provides, appropriately, for considerable deference, once acceptable procedures have been followed. Where there is such a taint, the courts closely scrutinize director conduct. And, as we have discussed in the previous Part and in earlier work, there are some types of cases where courts do more than defer and less than closely scrutinize, including cases involving takeovers, interference with the shareholder franchise, and some board decisions to terminate derivative suits. Cases implicating the duty of good faith also yield intermediate scrutiny.

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63. Hill & McDonnell, Disney, *Good Faith, and Structural Bias*, *supra* note 3, at 853.

64. *See supra* note 2; *see also* Julian Velasco, *Structural Bias and the Need for Substantive Review*, 82 WASH. U.L.Q. 8921 (2004).

65. Hill & McDonnell, *supra* note 2, at 1792–94.

66. For ease of exposition, this formulation glosses over the duty of loyalty violation inherent even in duty of care breaches: that the agent is taking more leisure than she is entitled to, at the expense of her principal.

But this has not been enough to make agents act optimally, with due regard for their principal. One need only consider executive compensation, discussed in Part VI. Acceptable procedures are indeed followed: due deliberation, after sufficient review of relevant materials prepared by outsiders with expertise and (nominal) independence. There is no conflict as that term is traditionally defined: people are not setting their own compensation, or the compensation of those with whom they have relationships the law would recognize as yielding a conflict. Nor are the decision makers acting in bad faith, as that term has thus far been defined. Still, it is hard to view executive compensation as a decision made by critically-minded people whose only duty is to their principal, the company (and its shareholders). There are countless examples of stratospheric pay awarded for poor or even disastrous performance.<sup>67</sup> The mindset behind such compensation is clear: cronies rewarding cronies.

The general willingness of boards to defer to management decisions regarding takeovers provides another example. Too often, management rejects an acquirer that they do not like, and that presumably would not keep them on were it to acquire the company, or rejects one acquirer for another largely (if not exclusively) because the acquirer they like will give them better terms. Boards comprised of people other than executives abiding by the pernicious golden rule, or those beholden to the management, might be less apt to approve such decisions. Many examples exist of deals that look like the product of excessive board deference to management. Two notable ones follow. The first is *Revlon*,<sup>68</sup> where the directors favored Forstmann Little over Pantry Pride because Forstmann would help the directors avoid a lawsuit by shareholders who had tendered their shares for notes based on an assurance of the notes' value. The second is *Schreiber v. Burlington Northern, Inc.*<sup>69</sup> The Court sets forth the facts as follows:

On December 21, 1982, Burlington Northern, Inc., made a hostile tender offer for El Paso Gas Co. . . . Burlington proposed to purchase 25.1 million El Paso shares at \$24 per share. . . . El Paso management initially opposed the takeover, but its shareholders responded favorably, fully subscribing the offer by the December 30, 1982, deadline.

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67. BEBCHUK & FRIED, *supra* note 52.

68. *Revlon, Inc., v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 175–76 (Del. 1986).

69. 472 U.S. 1 (1985).

Burlington did not accept those tendered shares; instead, after negotiations with El Paso management, Burlington announced on January 10, 1983, the terms of a new and friendly takeover agreement. Pursuant to the new agreement, Burlington undertook, *inter alia*, to (1) rescind the December tender offer, (2) purchase 4,166,667 shares from El Paso at \$24 per share, (3) substitute a new tender offer for only 21 million shares at \$24 per share, (4) provide procedural protections against a squeeze-out merger of the remaining El Paso shareholders, and (5) recognize “golden parachute” contracts between El Paso and four of its senior officers. By February 8, more than 40 million shares were tendered in response to Burlington’s January offer, and the takeover was complete.

The rescission of the first tender offer caused a diminished payment to those shareholders who had tendered during the first offer. The January offer was greatly oversubscribed and consequently those shareholders who retendered were subject to substantial proration.<sup>70</sup>

The case was brought under section 14(e) of the Securities Exchange Act of 1934; the plaintiff claimed that the transaction violated the section’s prohibition of “fraudulent, deceptive, or manipulative acts or practices . . . in connection with any tender offer.”<sup>71</sup> The plaintiff’s claim was that the offer was “manipulative.” The Court held that:

Nowhere in the legislative history is there the slightest suggestion that § 14(e) serves any purpose other than disclosure, or that the term “manipulative” should be read as an invitation to the courts to oversee the substantive fairness of tender offers; the quality of any offer is a matter for the marketplace.<sup>72</sup>

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70. *Id.* at 2–4 (footnotes omitted).

71. Securities Exchange Act of 1934 § 14(e) (codified as amended at 15 U.S.C. § 78n(e) (2006)).

72. *Schreiber*, 472 U.S. at 11–12 (footnote omitted).

The plaintiff therefore lost. No state corporate claim of breach of fiduciary duty is reported—presumably, the plaintiff’s lawyers concluded such a case was not worth bringing.

What was happening in this case? Any sensible reading makes the following conclusion inevitable: directors caused the acquirer to withdraw its offer and substitute an offer less favorable to shareholders and more favorable to management. In the first offer, shareholders could sell 25.1 million shares; in the second, they could only sell 21 million. That shareholders wanted to sell is demonstrated by their reaction to both offers—the first was fully subscribed, and the second one was “greatly oversubscribed.” Can anyone think a board with undivided loyalty to the corporation and its shareholders would have acted in this way?

The El Paso directors could justify their actions based on the squeeze-out protections: shareholders did get something in the new deal that they had not gotten in the old deal. We can be sure that the directors were well advised by counsel as to how to assure that they gave (and documented that they gave) careful consideration to all their actions and options. We can also be sure that there were no structural conflicts—that nobody approved his own golden parachute. But, again, any sensible reading screams out that the directors were favoring their own interests over those of the shareholders. It seems likely that the new standards for breach of the duty of good faith would not cover this situation either. While it nominally might seem to fit within one of the categories of good faith violation described in the *Disney* decision—where the director “intentionally acts with a purpose other than that of advancing the best interests of the corporation”<sup>73</sup>—directors would again point to the squeeze-out protections and presumably prevail.

Law, in its traditional sense, is apparently not fully able to do what the corporation and its shareholders need it to do: make agents live up to their fiduciary duty to act with undivided loyalty to their principals. The duty of care does not work; it does not even serve as a source of liability given DGCL section 102(b)(7).<sup>74</sup> But we do not want to dismiss the role played by the duty of care too easily: We will argue in the next Part that the words of the law have expressive force, too, and invoke extra-legal forces such as reputation. The duty of care, therefore, has force well beyond its ability to yield sanctions for violations. Certainly, notwithstanding the duty’s toothlessness as a source

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73. *In re The Walt Disney Co. Deriv. Litig.*, 906 A.2d 27, 67 (Del. 2006) (quoting *In re The Walt Disney Co. Deriv. Litig.*, 907 A.2d 693, 755 (Del. Ch. 2005)).

74. DEL. CODE ANN. tit. 8, § 102(b)(7) (2009).

of legal liability, law firms routinely advise directors to abide by their duty of care. But that does not help much either: It is easy to game procedure, complying in fact but not in spirit. Consider in this regard the procedures followed, post-*Van Gorkom*, by boards considering a merger to show they have abided by their duty of care, including most notably the acquisition of a (costly) fairness opinion (and the careful documenting by (costly) lawyers of the decision-making process). Many scholars think the main beneficiaries of this “duty” are investment bankers and lawyers, not the corporation or its shareholders.<sup>75</sup> The duty of loyalty does not work either, given that breaches are defined so narrowly. What about the expansion via the duty of good faith and the broader penumbra of the now enlarged duty of loyalty concept? As we argued above, the duty of good faith has thus far been construed narrowly, to require *intentional* conduct (or misconduct).

Moreover, as to all the fiduciary duties, the force of doctrine will necessarily be limited where we cannot set forth *ex ante* procedures or outcomes we want to require or prohibit. We do not want judges to micromanage corporate decision making, and we do not want corporate actors to be too susceptible to a court’s attempt to glean norms of the “you know it when you see it” variety. The specter of structural bias is ubiquitous enough, and the decisions are complex enough, requiring good business judgment, that close judicial scrutiny as employed in traditional loyalty analysis seems ill-advised. Business persons, not judges, have the best experience to make business decisions, and courts risk undermining the fundamental distribution of authority to boards if they intervene too frequently or too intricately in board decisions.<sup>76</sup> Yet, market forces on their own, though constraining, seem to fall short of encouraging a critical mindset. This leaves open the door for a role for the law in helping to shape behavior using forces other than the credible threat of legal liability. Others have remarked upon and discussed this distinction between legal standards that lead to liability and legal standards that may influence behavior but do not lead to liability. We discuss their work in the next Part, and build on it and extend it in several ways in the remainder of this Article.

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75. See Hill & O’Hara, *supra* note 55, at 1789–90.

76. BAINBRIDGE, *supra* note 40, at 120–26.

### III. COMMENTARY ON THE PENUMBRA

Delaware judges have themselves commented on their norm-setting role, although they do not always use the term “norm.” An interesting recent example is *Delaware’s Guidance: Ensuring Equity for the Modern Witenagemot*, written by Delaware Supreme Court Chief Justice Myron Steele (co-written with J.W. Verret).<sup>77</sup> This Article surveys three sorts of extra-judicial activities by Delaware judges: speeches and articles, dicta, and membership in formal policymaking bodies such as ABA committees.<sup>78</sup> Steele and Verret focus on the guidance function that these activities perform. They argue that for good reasons, corporate fiduciary duty law has a good deal of indeterminacy. Fiduciary duties “rise and fall with the tides of human conscience” and set expectations that must apply to evolving business circumstances.<sup>79</sup> However, this indeterminacy creates costs due to the uncertainty it creates for business planning. The extra-judicial activities they discuss help reduce uncertainty while still giving courts flexibility to apply evolving standards.

In another recent article, former Chief Justice E. Norman Veasey focuses on the role of judges in shaping best practices in corporate governance.<sup>80</sup> Of particular note is Veasey’s analysis of the importance of procedural posture.<sup>81</sup> Many important statements concerning frowned-upon behavior occur in motions to dismiss, based sometimes on extreme allegations of misbehavior, before defendants have had a chance to disprove bad facts or prove good ones. Ultimately, these defendants are usually not held liable. Yet as Veasey says, “an opinion that raises questions or teaches without imposing liability may provide guidance to the corporate world to conform to best practices without the downside of actually imposing personal liability.”<sup>82</sup>

Shortly after stepping down as a Chancery Court judge, William Allen wrote an article explicitly noting the role of Delaware decisions in shaping

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77. Myron T. Steele & J. W. Verret, *Delaware’s Guidance: Ensuring Equity for the Modern Witenagemot*, 2 VA. L. & BUS. REV. 189 (2007).

78. *Id.* at 192.

79. *Id.* at 194.

80. E. Norman Veasey & Christine T. Di Guglielmo, *What Happened in Delaware Corporate Law and Governance from 1992–2004? A Retrospective on Some Key Developments*, 153 U. PA. L. REV. 1399, 1404 (2005).

81. *Id.* at 1406.

82. *Id.*

norms.<sup>83</sup> In the article, Allen recognizes Melvin Eisenberg's distinction between standards of conduct and standards of review, and asks what point might be served by having judicial decisions that denounce bad conduct without imposing liability. His answer is that the law is in part "*an expression of community ideals* designed to inspire solidarity around certain values."<sup>84</sup> This works because most officers and directors are not Holmesian bad men, but rather persons who conform to norms because of "their own sense of moral worth."<sup>85</sup>

Several legal scholars have made crucial contributions to understanding the norm-setting function of the Delaware courts. One such contribution is Melvin Eisenberg's distinction, referred to above, between standards of conduct and standards of review.<sup>86</sup> In his terminology, a standard of conduct "states how an actor should conduct a given activity or play a given role," while a standard of review "states the test a court should apply when it reviews an actor's conduct to determine whether to impose liability or grant injunctive relief."<sup>87</sup> Eisenberg notes that standards of conduct serve "as a foundation for private standards of conduct,"<sup>88</sup> a point that is central to our analysis. He notes that this message is sometimes sent through legal advice by lawyers advising clients, and sometimes by corporate codes of conduct.<sup>89</sup>

Eisenberg discusses several justifications for the divergence between standards of conduct and standards of review. One is that the courts want to give two messages to directors and officers: they must act with due care, but we (the courts) will give them "running room" so they are not too risk averse.<sup>90</sup> A second justification is that the courts want to tell directors and officers to act with due care, but they also want to be fair and account for the difficulty courts have in determining whether decisions are reasonable.<sup>91</sup> As for the duty of loyalty, one justification for the distinction is that courts are

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83. William T. Allen, *The Corporate Director's Fiduciary Duty of Care and the Business Judgment Rule Under U.S. Corporate Law*, in *COMPARATIVE CORPORATE GOVERNANCE: THE STATE OF THE ART AND EMERGING RESEARCH* 307 (K.J. Hopt et al. eds., 1998).

84. *Id.* at 329 (emphasis in original).

85. *Id.*

86. Melvin Aron Eisenberg, *The Divergence of Standards of Conduct and Standards of Review in Corporate Law*, 62 *FORDHAM L. REV.* 437 (1993).

87. *Id.* at 437.

88. *Id.* at 464.

89. *Id.*

90. *Id.* at 465.

91. *Id.*



sending different messages to different actors.<sup>92</sup> To primary actors (officers, mainly), the courts' message is that they should act with due care and regard for corporate interests. To corporate reviewing organs (the board, mainly), the courts' message is that they should review the conduct of the officers according to the standard of conduct established under the duty of loyalty, and exercise due care in reviewing that conduct, knowing that approval will protect that conduct from liability if it meets the relevant standard of review.<sup>93</sup> A final justification for the conduct/review divergence is that standards of conduct are directed at primary actors, who often act without detailed legal advice and need simple principles, while standards of review are directed at courts and boards, bodies that know the law or are advised by lawyers who do, and thus such standards can be more complex and legalistic.<sup>94</sup>

The previous articles that probably come closest to our analysis of the norm-setting function of Delaware courts are by Edward Rock, sometimes on his own,<sup>95</sup> and sometimes with Michael Wachter.<sup>96</sup> In his article *Saints and Sinners*, Rock argues that Delaware law operates largely through “sermons”<sup>97</sup> or “morality play[s].”<sup>98</sup> These sermons occur in Delaware cases, but also in speeches and papers by Delaware judges.<sup>99</sup> Rock hypothesizes that the messages of the sermons are transmitted to corporate directors and officers in good part through the advice of corporate counsel.<sup>100</sup> These sermons work by shaming bad actors and by helping to set corporate norms. Norms, in turn, matter because the world of officers and directors of large U.S. corporations is a “surprisingly small and close-knit community” where norms and shaming can have a powerful effect.<sup>101</sup>

That, then, is a brief picture of the relevant legal landscape, how it has evolved, and how that legal evolution has occurred along with, and tied to, a change in the composition and expected behavior of boards of directors. We

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92. *Id.*

93. *Id.*

94. *Id.* at 466.

95. Edward B. Rock, *Saints and Sinners: How Does Delaware Corporate Law Work?*, 44 UCLAL. REV. 1009 (1997).

96. Edward B. Rock & Michael L. Wachter, *Islands of Conscious Power: Law, Norms, and the Self-Governing Corporation*, 149 U. PA. L. REV. 1619 (2001).

97. Rock, *supra* note 95, at 1016.

98. *Id.* at 1047.

99. *Id.* at 1068–70.

100. *Id.* at 1070–72.

101. *Id.* at 1013–14.

also have seen how other scholars have analyzed the distinction between standards of conduct and standards of review, in Eisenberg's terms. These commentators sometimes use different terminology—norms, standards of conduct, shaming—but they all address what we call “the penumbra of Delaware corporate law,” the part of “law” beyond law on the books and as enforced by judges that nevertheless influences the behavior of corporate actors, especially directors and officers. In the next Part, we explain what the penumbra of Delaware law consists of, and how it works.

#### IV. THE PENUMBRA OF DELAWARE CORPORATE LAW

What is in the penumbra? As discussed briefly in the previous Part, the penumbra includes pronouncements by Delaware judges other than their opinions. Some Delaware corporate law judges are quite active in the corporate governance debate: they write articles, give interviews to the media, or speak at legal conferences. Moreover, even within the courtroom, the judges express their views in a manner intended to influence behavior through norms, rather than the sanctioning power of law. Consider in this regard Vice Chancellor Strine's comment at the beginning of this Article. Consider as well language in another Chancery Court case:

[T]he settlement in the Court's opinion leaves much to be desired.

The Court's role in reviewing the proposed Settlement, however, is quite restricted. If the Court was a stockholder of Occidental it might vote for new directors, if it was on the Board it might vote for new management and if it was a member of the Special Committee it might vote against the Museum project. But its options are limited . . . .<sup>102</sup>

The court is telling the defendants that it does not think highly of their conduct, but that it does not have the power to sanction them. Presumably, the court is not just venting—it is hoping to influence behavior.

The penumbra also includes advice given by the corporations' law firms. Firms give specific advice for specific situations, and they frequently write memos (often posted on their websites as advertisements for their services),

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102. Sullivan v. Hammer, No. 10823, 1990 WL 114223, at \*4 (Del. Ch. Aug. 7, 1990), *cited in* Hill & McDonnell, *supra* note 2, at 1795 n.130.

summarizing and explaining the latest cases and developments, including pronouncements by Delaware judges.<sup>103</sup> In this regard, advice-giving corporate counsel are a ubiquitous part of life in a large, modern corporation. These lawyers are a central mechanism by which the norms and expectations of Delaware judges are conveyed to officers and directors.

Additionally, the penumbra includes some of the more influential views in the corporate governance debate. In this regard, consider the enormous wealth of materials online that include “best practices” and other recommendations for corporate actors. One prominent voice is that of CalPERS, the California public pension fund; CalPERS is also a plaintiff in many shareholder suits, as are several other pension funds. CalPERS hosts a corporate governance website that describes at great length CalPERS’ philosophy about how corporations should be run, and discusses the actions CalPERS is taking to get corporations to do its bidding.<sup>104</sup> Two other major corporate governance websites are [www.corpgov.net](http://www.corpgov.net) and [www.thecorporatelibrary.com](http://www.thecorporatelibrary.com). Another influential (and quite controversial) source of “corporate law” on this view is RiskMetrics Group (formerly Institutional Shareholder Services).<sup>105</sup> Directors who do not vote in a manner viewed favorably by RiskMetrics risk losing their seats, since many shareholders follow RiskMetrics’ voting recommendations.

Much of this “law” has a distinctly pro-shareholder bias,<sup>106</sup> but not all. Memos from the law firm of Wachtell, Lipton, Rosen & Katz, one of the

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103. *See, e.g.*, Cleary, Gottlieb, Steen & Hamilton LLP, <http://www.cgsh.com/News/Search.aspx> (follow “PUBLICATIONS: More” hyperlink) (last visited Sept. 12, 2009); Debevoise & Plimpton LLP, <http://www.debevoise.com/newseventspubs/publications/> (last visited Sept. 12, 2009); Dewey & LeBocuf LLP, <http://www.deweylebocef.com/cn/Idcas.aspx> (last visited Sept. 12, 2009); Fried, Frank, Harris, Shriver & Jacobson LLP, <http://www.ffhsj.com/index.cfm?pageID=7> (last visited Sept. 12, 2009); Mayer-Brown LLP, <http://www.mayerbrown.com/publications/index.asp> (last visited Sept. 12, 2009); Skadden, Arps, Slate, Meagher & Flom LLP, <http://www.skadden.com/Index.cfm?contentID=6> (last visited Sept. 12, 2009); Sullivan & Cromwell LLP, <http://www.sullcrom.com/publications/> (last visited Sept. 12, 2009); Willkie Farr & Gallagher LLP, <http://www.willkie.com/firm/pubs.aspx> (last visited Sept. 12, 2009).

104. CalPERS, Corporate Governance, <http://www.calpers-governance.org/> (last visited Sept. 12, 2009). There are many other influential corporate governance blogs. *See, e.g.*, Harvard Law School Forum on Corporate Governance and Financial Regulation, <http://blogs.law.harvard.edu/corpgov/> (last visited Sept. 12, 2009).

105. RiskMetrics Group, <http://www.riskmetrics.com/> (last visited Sept. 12, 2009).

106. The [www.corpgov.net](http://www.corpgov.net) home page begins as follows: “Since 1995 the Corporate Governance website at CorpGov.net has facilitated the ability of institutional and individual shareowners to better govern corporations, enhancing both corporate

world's top corporate law firms, emphasize the benefits of managerial power and discretion.<sup>107</sup> Some recent articles and dicta do so as well, such as Vice Chancellor Strine's arguments on the common interests of management and labor,<sup>108</sup> as well as a recent decision in which he favored deference to management.<sup>109</sup>

Part of "corporate law" also involves the proxy process. Law governs which shareholder proxy proposals are included in management's proxy statements.<sup>110</sup> It does not, however, govern whether management must adopt a proposal that is only precatory, as most shareholder proposals are. Law in its pure form—as a possible source of liability if its dictates are not followed—has a very limited reach. Its penumbra is far broader, and much of what directors do when they make efforts to comply with "the law" reaches far into that penumbra. The penumbra is thus an important influence on corporate director behavior.

How does the penumbra work? A good starting point for our discussion is an observation about Delaware corporate law, a bit less true today than when first made, but still carrying considerable force: that directors are more likely to be struck by lightning than to be found liable for breaching their fiduciary duty.<sup>111</sup> Indeed, when we teach fiduciary duty concepts, but explain that directors almost certainly will not be paying out-of-pocket for violations of duties given possibilities for exculpation under DGCL section 102(b)(7), indemnification, or insurance, astute students sometimes ask: What's left?

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- accountability and the creation of wealth." Corporate Governance, <http://www.corpgov.net> (last visited Sept. 12, 2009).
107. See, e.g., David A. Katz & Laura A. McIntosh, *Corporate Governance Update: Populists' Wish Lists Offer Legislative Parade of Horribles*, July 23, 2009, <http://blogs.law.harvard.edu/corpgov/files/2009/07/populists-wish-lists-offer-legislative-parade-of-horribles.pdf>; Martin Lipton et al., *A Crisis is a Terrible Thing to Waste: The Proposed "Shareholder Bill of Rights Act of 2009" Is a Serious Mistake*, May 12, 2009, <http://wlrk.com/webdocs/wlrknew/WLRKMemos/WLRK/WLRK.16657.09.pdf>; Posting of Martin Lipton, *Corporate Governance in Crisis Times*, to The Harvard Law School Forum on Corporate Governance and Financial Regulation, <http://blogs.law.harvard.edu/corpgov/2009/07/20/corporate-governance-in-crisis-times/> (July 30, 2009, 9:29 EST).
108. Leo Strine, Jr., *Toward Common Sense and Common Ground? Reflections on the Shared Interests of Managers and Labor in a More Rational System of Corporate Governance*, 33 J. CORP. L. 1, 3 (2007).
109. *Mercier v. Inter-Tel (Del.)*, Inc., 929 A.2d 786 (Del. Ch. 2007).
110. 17 C.F.R. § 240.14a-8 (2009).
111. See Bernard Black et al., *Outside Director Liability*, 58 STAN. L. REV. 1055, 1139-40 (2006); Margaret M. Blair & Lynn A. Stout, *Trust, Trustworthiness, and the Behavioral Foundations of Corporate Law*, 149 U. PA. L. REV. 1735, 1791 (2001), cited in Hill & McDonnell, *supra* note 2, at 1772 n.15.

What does it mean to have a duty that you can violate without at least monetary sanction?

The answer is, of course, that what corporate law is considered to require, or the ways in which parties subject to corporate law comply with the law, is not coextensive with what parties can be punished for violating. What we teach as “corporate law,” and what we regard to be “corporate law,” includes a considerable penumbra, including as it does “duties” the violation of which would not yield a sanction. Consider the typical law firm memo describing a director’s fiduciary duties: It goes well beyond what a director must do to avoid liability, often spending considerable time parsing the sometimes expansive dicta in Delaware corporate law opinions.

A typical example of such a memo advising compliance with the law’s penumbra is an analysis in *Health Lawyers Weekly* of a recent bankruptcy case involving *Caremark* duties for corporate officers.<sup>112</sup> The case, *Miller v. McDonald*,<sup>113</sup> involved a bankruptcy trustee’s complaint alleging breach of fiduciary duty against corporate officers, including the general counsel. The Delaware bankruptcy court held that *Caremark* duties apply to corporate officers, including the general counsel, and that the general counsel could potentially be held liable for aiding and abetting violations of fiduciary duty.<sup>114</sup> The court denied a motion to dismiss; the defendants were thus still far from actually being held liable.

The memo, written by a lawyer at McDermott Will & Emery, describes the facts in the case, the basic law of *Caremark*, and the court’s decision in *Miller*. It does point out that the decision only addressed the motion to dismiss, and was not a finding of liability.<sup>115</sup> Nonetheless it concludes that:

At its core, the case speaks to the critical value attributed to organizational commitment to corporate compliance, i.e., the potential that effective compliance systems possess to safeguard against wrongdoing by corporate officers, employees or agents. The board should respond to this decision with a renewed interest in providing effective compliance plan oversight.

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112. Michael W. Peregrine, *Caremark Duties Ascribed to General Counsel, Other Officers*, 6 *Health Law. Wkly.* 23 (June 13, 2008), available at <http://www.mwc.com/info/pubs/peregrine061608.pdf>.

113. *Miller v. McDonald*, 385 B.R. 576 (Bankr. D. Del. 2008).

114. *Id.* at 591–93.

115. Peregrine, *supra* note 112, at 2.

The court's refusal to dismiss the corporate waste/"aiding and abetting" allegations underscore [sic] the need for corporate leadership to be increasingly sensitive to the significant burdens being placed upon general counsel by legislation, regulation, and judicial decisions. This is critical.<sup>116</sup>

Thus, what is "required" or indeed routinely done on account of what is in the penumbra, is not the same as what is required and routinely done under law. Clearly directors do not simply "abide by" what is in the penumbra. That being said, it does influence their behavior in important ways. Judicial pronouncements and law firm memos are probably most closely adhered to. Beyond that, different directors and corporations will respond differently to other extra-legal forces. Some companies might still ignore precatory proposals passed with a large majority of the vote, but that is becoming increasingly less common.<sup>117</sup> Some directors are far more influenced than others to vote in a manner approved by RiskMetrics. Some companies are more influenced than others to comply with the best practices specified by RiskMetrics or CalPERS or other organizations formulating and publicizing their views. Some are more influenced than others by demands of activist shareholders like Carl Icahn, a "reformed" corporate raider who has reinvented himself as a champion for shareholder rights.<sup>118</sup> Indeed, Icahn influenced Yahoo! to replace some of its board members with directors he

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116. *Id.* at 3.

117. Yonca Ertimur et al., *Board of Directors' Responsiveness to Shareholders: Evidence from Shareholder Proposals*, (Harvard Business School Working Paper, No. 08-048, 2008), available at <http://www.hbs.edu/research/pdf/08-048.pdf>. The abstract notes that: "The frequency of implementation [of shareholder resolutions] has almost doubled after 2002, reaching more than 40%. Shareholder pressure (e.g. the voting outcome and the influence of the proponent) and the type of proposals are the main determinants of the implementation decision, while traditional governance indicators do not seem to matter. Outside directors implementing MV [majority vote] shareholder proposals experience a one-fifth reduction in the likelihood of losing their board seat and in the likelihood of losing other directorships."

118. See The Icahn Report, <http://www.icahnreport.com/> (last visited Sept. 12, 2009). For an argument that Icahn is actually advancing his own interests to the detriment of shareholders, see Lynn A. Stout, *Op-Ed., Why Carl Icahn Is Bad for Investors*, WALL ST. J., Aug. 1, 2008, at A11, available at <http://online.wsj.com/article/SB121754688222002635.html>.

designated.<sup>119</sup> He also prevailed in his proxy fight at Amylin Pharmaceuticals, getting elected to the board and ousting the CEO.<sup>120</sup> His letter to the Chairman of the Board began:

Amylin is a prime example of what is wrong with the corporate governance of most American public companies.

We agree with you that the board of Amylin should change. However, three major stockholders of Amylin, namely Eastbourne, ourselves and, significantly, Ted Greene — Amylin’s co-founder, all agree that the obvious choice for the first director to leave Amylin’s board is you.<sup>121</sup>

Especially given his recent successes, directors may want to appease Icahn to avoid being targeted by him for removal.

Why do directors do more than the law requires? First, they want some margin of safety beyond just avoiding liability.<sup>122</sup> They would also like, of course, to minimize the chance they will even be sued: Coming “close to the line” is generally not the applicable ethos, except perhaps in contentious takeover battles or for a director valuing a reputation as aggressive. Thus, to some extent the penumbra acts as a sort of safe harbor. By engaging in the kind of best practices praised by Delaware judges, even though doing so is not required, officers and directors reduce to nearly zero the already extremely small chances of legal liability. This accounts for why they pay close attention to what their companies’ law firm memos advise; it accounts as well for their acting in accordance with the non-binding pronouncements of the Delaware judiciary. To some extent, agency costs are implicated. At times, firms might benefit from more aggressive behavior by their directors

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119. Peter Kafka, *Yahoo, Icahn Settle: Carl Gets Three Seats, Ends Proxy Fight*, July 21, 2008, <http://finance.yahoo.com/tech-ticker/article/41020/Yahoo-Icahn-Settle-Carl-Gets-Three-Seats-Ends-Proxy-Fight>.

120. See *In Victory for Icahn, Amylin Chairman is Ousted*, N.Y. TIMES, June 2, 2009, <http://dealbook.blogs.nytimes.com/2009/06/02/in-victory-for-icahn-amylin-chairman-is-ousted/>.

121. Letter from Carl Icahn to Joseph C. Cook, Chairman of the Board of Amylin Pharmaceutical, Inc., (Apr. 15, 2009), <http://news.prnewswire.com/DisplayReleaseContent.aspx?ACCT=104&STORY=/www/story/04-15-2009/0005006461&EDATE=>.

122. Of course, all of this glosses over the role of settlement, indemnification and insurance. See generally Tom Baker & Sean J. Griffith, *The Missing Monitor in Corporate Governance: The Directors’ and Officers’ Liability Insurer*, 95 GEO. L.J. 1795 (2007); Tom Baker & Sean J. Griffith, *Predicting Corporate Governance Risk: Evidence from the Directors’ and Officers’ Liability Insurance Market*, 74 U. CHIL. L. REV. 487 (2007).

and less spending on law firms advising on the law and penumbra. But directors have the ability to spend firm money on something that benefits them without regard to whether it benefits the firm, and so they do.

What about the remainder of the penumbra? Why adopt a precatory shareholder proposal that has passed with a majority of votes? Why adopt such a proposal when it has gotten a respectable percentage, but less than a majority of the votes? Why follow CalPERS' best practices? One obvious answer is fear that a proxy contest will be mounted to replace the directors if they do not do what seems to be the shareholders' bidding. Another is that to the extent a norm arises to abide by a particular practice, directors will suffer reputational costs if they do not abide by it. Here we start to see a dark side to the penumbra, a point to which we will return shortly.

A related explanation for obedience to widely-recognized social norms is that that is what people often do: they follow norms.<sup>123</sup> Norms become internalized, and hence are followed independent of the possibility of sanctions for violation. If the norm is murky, or if the benefits from violating it are high enough, people will stray. But as long as the norm's directives are fairly clear, and following the norm is not too inconsistent with one's self-interest, many, if not most people will abide by it. This is particularly true to the extent that the world of large corporate officers and directors is a relatively small and close-knit community, as described by Rock.<sup>124</sup> In such communities, it is hard to tell where reputation and social sanctions stop and norm internalization begins.

Pronouncements by Delaware judges play an important role in these reputational and norm-following mechanisms. For the mechanisms to work, there must be fairly well-understood and widely agreed-upon rules for what directors should do in performing their jobs. In a complicated and always-changing business world, it will often be unclear what norms of good behavior require. It is extremely helpful to have a central source that most actors in the system accept as a respected and accurate arbiter of good behavior. Delaware judges play that role well enough and, we would argue, better than any other plausible actor in the relevant sphere.

One should also ask where Delaware judges obtain their understanding of what is required of well-behaved corporate boards. One important source is their observation of best practices in well-respected, well-run public

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123. See Allen, *supra* note 83, at 329; see also Christine Jolls et al., *A Behavioral Approach to Law and Economics*, 50 STAN. L. REV. 1471, 1496–97 (1998).

124. Rock, *supra* note 95, at 1013–14.



corporations. Thus we see a feedback loop. New best practices emerge in leading companies. Delaware judges point to those practices in scolding parties before them from less-well-run companies. Through the various communication mechanisms discussed above, these judicial pronouncements are spread to the directors of other boards, and the new practices become more widespread. As a particular practice becomes more and more entrenched, failing to follow it leaves a company increasingly open to criticism should it wind up in court, thereby increasing the incentives to adopt the practice.

How effective the penumbral mechanisms we discuss here really are remains an open empirical question, one unlikely to be resolved any time soon. How would we measure the effects in isolation? Thus, we cannot know how valuable the penumbra is, nor can we even prove that it is valuable at all. We certainly can see considerable room for improvement. The current financial crisis, like the ones before it, clearly shows that great holes remain in our corporate governance system, despite the penumbra. We do think, however, that even absent proof, the available evidence suggests that the penumbra does serve as a valuable constraint on directors, and without it, things would likely be even worse. Consider fields in which it is arguably the case that abiding by the letter of the law, while perhaps violating the spirit, is deemed acceptable, such as corporate tax compliance. Corporations and their officers and directors are excellently situated to get expensive advice to help them do precisely what law on the books and as enforced requires. The immediate response to *Van Gorkom*—a full employment act for lawyers and investment bankers with only minimal substantive benefit to the corporation and its shareholders—shows how corporate law without a penumbra might operate. Some directors follow just the letter of the law, and some also follow its spirit (and some follow neither). Many directors follow the letter and spirit in some circumstances and merely the letter in others. A key method for improving corporate governance is to expand the domain in which directors actively abide by the norms of good conduct enunciated in the penumbra—essentially, the law's spirit—and to contract the domain in which directors merely do what they must to avoid legal liability.

## V. THE DARK SIDE OF THE PENUMBRA

We do not mean to depict the penumbra in unambiguously positive terms. The penumbra has a dark side as well. The penumbra effectively consists of norms. Two norms-fueled approaches to corporate governance, one a matter of substance and one a matter of procedure, are vulnerable to

the charge that they have become influential through a process that does not give full weight to appropriate competing interests. One such approach is the shareholder primacy norm that gives shareholders ever-increasing powers.<sup>125</sup> The other is the checklist approach to corporate governance, wherein some checklist of best practices is advanced as desirable, without sufficient evidence, and there is punishment, in the form of reputation loss and perhaps loss of jobs for directors, for not abiding by the checklist. As between shareholders and directors and, for that matter, as between shareholders and other constituencies, the appropriate division of powers is very much an open issue.<sup>126</sup> The checklist approach, typically advancing changes in the name of shareholder primacy, is open to criticism on that ground and on grounds that nobody knows whether what it promotes is a good idea, even for advancing shareholder interests or for advancing the corporation's interests. These criticisms are often, and vociferously, made.<sup>127</sup>

Why do they not carry the day? How can we argue that extra-legal forces should have even more power than they do, given the perils we have described? We have two main arguments in response. One is that, of course, the trajectory of the law proceeds not only through pressure on traditional law-making bodies, but also through its effects on, and the consequent reactions of, other affected parties. That is, a penumbra is inevitable, be it optimal or not; what we propose to a large extent is something that would happen even if courts did not consciously encourage it. When a company is sued to force it to include a shareholder proposal on its management proxy statement, and allows the proposal rather than proceeding with the suit, we think that certainly in the short term, that is an acceptable way to proceed.

Much more importantly, whomever the principal is—the corporation, at least, but perhaps also the shareholders—it is clear who the principal is *not*: the company board and management. It is also clear that structural bias has run amuck, yielding boards that defer too much to management, where management has too great a sense of entitlement. The traditional duties of

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125. See Lucian Aryc Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833 (2005).

126. See, e.g., Brett H. McDonnell, *Employee Primacy, or Economics Meets Civic Republicanism at Work*, 13 STAN. J.L. BUS. & FIN. 334 (2007); Brett H. McDonnell, *Professor Bainbridge and the Arrovian Moment*, 34 DEL. J. CORP. L. 139 (2009).

127. See, e.g., Jeffrey Sonnenfeld, *Good Governance and the Misleading Myths of Bad Metrics*, 18 ACAD. MGMT. PERSP. 108 (2004); see also Robert Daines et al., *Rating the Ratings: How Good are Commercial Governance Ratings?* (Rock Ctr. for Corporate Governance at Stanford Univ., Working Paper No. 1), available at [http://www.law.stanford.edu/display/images/dynamic/publications\\_pdf/dgl6-26-2008\\_1.pdf](http://www.law.stanford.edu/display/images/dynamic/publications_pdf/dgl6-26-2008_1.pdf); Hill & O'Hara, *supra* note 55, at 1785 n.289.

care and loyalty are the easy ones to specify and articulate, at least comparatively speaking. It is the vast middle ground—the difference between what the director does and what a truly critically-minded director would do—that is hard. Depending on who we think the principals are, we may have different views on what the directors should do. But we know what they should not do: pay themselves massive “bonus” compensation for indifferent or poor results, consider or reject corporate combinations to build themselves empires or to keep their jobs, etc. The law in its narrow, non-expressive sense is not equipped to make substance-based decisions on these points. We need therefore to marshal extra-legal forces—the specter of scrutiny, the holding up of cronyistic decision-making as such, and so on. Strine, in the introductory quote, does just that. He evocatively shames the company and the directors on the special committee, confronting them viscerally regarding their non-critical mindset, and for adopting a “going through the motions” role, where the outcome was pre-determined. It is an apt criticism of our argument that we like extra-legal forces when they are being marshaled for what, in our view, is the good. But we think that agent misbehavior is a pervasive problem that law is not equipped to address nearly as well as it should. We think that given agents’ ability to favor their own interests and act adversely to their principals, a counterweight is needed, and that the penumbra, while imperfect, nevertheless serves as a good and necessary counterweight.

## VI. EXECUTIVE COMPENSATION

Executive compensation presents an excellent case for our theory. In recent decades, the compensation of top American executives in public corporations has soared as it has increasingly taken the form of stock options and other sorts of equity-based instruments. This move was encouraged by reformers who thought equity-based compensation would more closely align the interests of executives and shareholders. Regulation encouraged the move, particularly through the tax code.<sup>128</sup>

The effects of this new form of compensation are fiercely disputed. Some believe it has accomplished its goal and encouraged beneficial risk-taking and a greater focus on shareholder value. Others believe that the process of setting compensation in public corporations is captured by the executives themselves, who control the board composition and who put there

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128. *See, e.g.*, I.R.C. § 162(m) (2008).

like-minded top executives from other corporations who have no inclination to derail this gravy train. These critics claim that the new forms of compensation, particularly stock options, have encouraged short-term efforts to pump up stock prices, sometimes by out-and-out fraud. When the long-term costs of these short-term strategies become apparent, the CEOs who implemented them are sitting on the beach in the Bahamas.

There is heated debate between proponents of these two pictures of executive compensation, with Lucian Bebchuk and Jesse Fried providing the most detailed critique of compensation practices.<sup>129</sup> Many have in turn criticized Bebchuk and Fried.<sup>130</sup> It is hard to empirically sort out this debate, because most compensation practices can be given some sort of efficiency-based justification, but can also be seen in a more sinister light. It is very hard to compare existing practice to an ideal system, in part because the optimization problem is extremely complicated and we have few, if any, examples of how compensation would be set in public corporations not beset by the kind of structural bias that makes existing practices questionable. For present purposes, we simply assert that Bebchuk and Fried have more than held their own in this debate, and refer the reader to their responses to their critics.<sup>131</sup> Of course, we enter this debate already inclined to side with them insofar as we tend to believe that structural bias problems are widespread and not adequately corrected by market mechanisms. We have some surprising company in this view: Richard Posner, in a dissent to the denial of a petition for rehearing en banc in a case charging that a mutual fund adviser's fees were excessive, noted that "[c]ompetition in product and capital markets can't be counted on to solve the problem because the same structure of incentives operates on all large corporations and similar entities, including mutual funds."<sup>132</sup>

Consider how law on the books and as enforced in courts might try to regulate compensation. Is law going to set some dollar maximum? Presumably not. What about mandating some sort of procedure by "independent" directors? Been there, done that, and it has not helped. The stock exchanges require a Compensation Committee composed of

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129. BEBCHUK & FRIED, *supra* note 52.

130. For an overview of the debate, see Lucian A. Bebchuk & Jesse M. Fried, *Pay Without Performance: Overview of the Issues*, 30 J. CORP. L. 647 (2005).

131. *Id.*

132. *Jones v. Harris Assocs., L.P.*, 537 F.3d 728, 730 (7th Cir. 2008) (Posner, J., dissenting from denial of petition for rehearing and rehearing en banc), *cert. granted*, 129 S. Ct. 1579 (2009).

independent directors, and that committee is required to produce a report on executive officer compensation and make recommendations to the board.<sup>133</sup> This is the full employment act for compensation consultants, and it does nothing to address the less-than-critical determinations made by directors too deferential to management. Any proposed compensation amount can always be justified through some, probably costly, process.<sup>134</sup>

Indeed, law has historically had a difficult time regulating executive compensation. There are early cases finding compensation excessive, but more recent cases tend to be quite hands-off.<sup>135</sup> So long as a non-conflicted process is followed, compensation is rarely second guessed (at least in public corporations), even though structural bias is clearly implicated. Directors tend to be executive officers of other companies, so they start with the mindset that a high-pay package is appropriate. They also benefit from setting high executive pay packages given that their own compensation as officers of other companies is set in part by reference to those packages. And of course they depend on keeping officers' good favor in order to keep their jobs.

What to do? We know what happened when the market (with the help of the IRS) tried to take care of the problem.<sup>136</sup> At the time, shareholders were complaining that managers were getting paid fixed salaries regardless of performance. So, performance was linked to pay. But the rub was that there is no consensus way of measuring performance. Those receiving the compensation are in the perfect position to game the applicable performance measures—and they do. “Performance” for compensation purposes could have, and often had, little to do with true performance.<sup>137</sup> The result of linking pay with “performance” was that executive compensation increased exponentially—as did, in some cases, the risks taken by companies. Indeed, the current financial crisis owes significantly to “performance” based pay, as executives, particularly in financial service companies, were motivated to take enormous risks to produce stellar “performance.” When the “performance”

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133. NYSE<sup>1</sup>, Inc., Listed Company Manual, § 303A.05 (2009), available at <http://nysemanual.nyse.com/1.CMTools/PlatformViewer.asp?selectednode=chp%51%51%51%4&manual=%2F1cm%2Fsections%2F1cm%2Dsections%2F>.

134. See, e.g., *In re The Walt Disney Co. Deriv. Litig.*, 906 A.2d 27 (Del. 2006).

135. See MELVIN ARON EISENBERG, CORPORATIONS AND OTHER BUSINESS ORGANIZATIONS, 642 (9th ed. 2005).

136. I.R.C. § 162(m) (2008).

137. See BEBCHUK & FRIED, *supra* note 52.

was unmasked as something far less stellar, executives have nevertheless largely been able to keep the money, while the economy has crashed.<sup>138</sup>

One initiative that would seek to marshal extra-legal forces is “say on pay,” in which shareholders get a non-binding vote on executive compensation. In the United Kingdom, such votes are mandatory, and some research suggests that these votes can have an effect.<sup>139</sup> Some companies have voluntarily held “say on pay” votes; the Obama Administration has proposed requiring such votes,<sup>140</sup> and the TARP program does require such votes for companies receiving TARP funds.<sup>141</sup>

There is evidence that extra-legal forces—here, marshalling norms and outrage—could be effective in curtailing executive pay. Indeed, norms and outrage seem like plausible candidates to explain why European executive pay is so much lower than US executive pay: American corporate executives tend to earn much more than comparable European executives, in both absolute terms and relative to lower-level employees.<sup>142</sup> There are many potential explanations for this difference. However, one important explanation may be greater hostility among a variety of groups in Germany to high executive pay.<sup>143</sup>

Law on the books and as enforced by judges has a hard time with executive compensation precisely because we do not know how to articulate what counts as appropriate compensation, nor how to specify a procedure that will yield a determination we can and should respect. But excessive compensation may be something that we “know (at least well enough) when we see.” Indeed, several executives have already given back some portion of

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138. For a variant of this argument, see RICHARD A. POSNER, *A FAILURE OF CAPITALISM: THE CRISIS OF '08 AND THE DESCENT INTO DEPRESSION* 93–100 (2009).

139. Fabrizio Ferri & David A. Maber, *Say on Pay Votes and CEO Compensation: Evidence from the U.K.*, (June 15, 2009) (unpublished manuscript), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1420394](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1420394). Ferri and Maber find that while the legislation did not result in a “change in the level and growth rate of CEO pay after the adoption of say on pay,” there was an “increase in its [CEO compensation’s] sensitivity to poor performance,” particularly in “firms with excess CEO pay” and in “firms with high voting dissent.” *Id.* at Abstract.

140. See David Lawder, *Congress Gets Obama “Say on Pay” Proposal*, REUTERS, Jul. 16, 2009, <http://www.reuters.com/article/politicsNews/idUSTRI5616VJ20090716>.

141. American Recovery and Reinvestment Act of 2009 § 7001, Pub. L. No. 111-5, 123 Stat. 115 (amending 12 U.S.C. § 5221 (2006)). The SEC’s interpretive guidance on this provision is available at <http://www.sec.gov/divisions/corpfin/guidance/arrainterp.htm>.

142. Brian R. Cheffins, *The Metamorphosis of “Germany Inc.”: The Case of Executive Pay*, 49 AM. J. COMP. L. 497, 508–09 (2001).

143. *Id.* at 513–16.

their compensation, thanks to pressure and perhaps, to pre-empt litigation. Angelo Mozilo, former head of Countrywide Financial Corporation, maker of many defaulting subprime loans, comes to mind,<sup>144</sup> as do many of the recipients of bonuses from AIG.<sup>145</sup> Of course, for any CEO or other bonus recipient that has returned some money, many others who have not done so come to mind. The penumbra needs to gain force and focus in this regard.

Preliminary indications are mixed, but there have been some encouraging developments. The effects of the law's attempts, in this time of crisis, to address compensation may reverberate. Consider in this regard the recent decision holding that plaintiffs could proceed with their claim that a severance package to the departing Citigroup CEO was corporate waste.<sup>146</sup> Then again, this decision is filled with business judgment rhetoric that shows little to no outrage at the tremendous bungling of risk management that destroyed billions of dollars of shareholder value and helped send the U.S. financial system into its worst crisis since the Great Depression. Consider, too, the public pronouncements by President Obama and other government officials against excessive compensation, and of course, the stimulus legislation's inclusion of caps on compensation. One article's title is apt: *In Curbing Pay, Obama Seeks to Alter Corporate Culture*.<sup>147</sup> Then again, so far the Obama administration has not figured out effective forms of regulation of pay,<sup>148</sup> and there is strong opposition, both in boardrooms and in the political sphere. Pay limits are quite controversial, even among those who think executive pay

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144. Alex Veiga, *Countrywide's Mozilo Foregoing \$37.5 Million*, SFGATE.COM, Jan. 27, 2008, <http://www.sfgate.com/cgi-bin/article.cgi?f=/n/a/2008/01/27/financial/f211557S93.D1L>. Countrywide was taken over by Bank of America. . See Jody Shenn, *Bank of America Says 'Thank Goodness' for Countrywide*, BLOOMBERG.COM, Mar. 13, 2009, <http://www.bloomberg.com/apps/news?pid=20601087&sid=aDc2IcgvIIQI&refer=home>.

145. See Freifeld, *supra* note 7.

146. *In re Citigroup Inc. S'holder Deriv. Litig.*, 964 A.2d 106 (Del. Ch. 2009).

147. Stephen Labaton & Vikas Bajaj, *In Curbing Pay, Obama Seeks to Alter Corporate Culture*, N.Y. TIMES, Feb. 5, 2009, at A1, available at <http://www.nytimes.com/2009/02/05/us/politics/05pay.html>.

148. There have been other developments. Kenneth Feinberg, the Obama Administration's "pay czar," has restricted the compensation of executives at companies receiving government bailouts. The Federal Reserve has proposed rules aimed at discouraging pay that rewards risk-taking at organizations it regulates. Stephen Labaton, *Fed Plans to Vet Banker Pay to Discourage Risky Practices*, N.Y. TIMES, Oct. 23, 2009, at A1, available at <http://www.nytimes.com/2009/10/23/business/23pay.html>. On the Federal Reserve's proposed rules, see also Press Release, Bd. of Governors of the Fed. Res. Sys., Fed. Res. Issues Proposed Guidance on Incentive Comp. (Oct. 22, 2009) <http://www.federalreserve.gov/newsevents/press/bcreg/20091022a.htm>.

is generally too high.<sup>149</sup> We take no position as to whether particular legislation or court decisions are appropriate or correct in their curbs of, and responses to, executive compensation. We do, however, support what we think is one felicitous consequence of all the attention now focused on the issue: pressure on corporate boards to make compensation decisions that pass a “smell test.”

### CONCLUSION

Boards of directors are charged with monitoring company management. This monitoring function has expanded greatly in recent decades. Once, boards had a much greater proportion of insiders than they do today; hence, they would effectively have been monitoring “their own.” Thus, their focus was mainly on strategic decision-making, not monitoring. Today boards play a greater role, with outside directors expected to closely scrutinize the performance of corporate officers. Yet even with the growth of outside directors, boards consist largely of people selected by the management, with kindred worldviews. Directors are not only typically beholden to company management for their director jobs; they also may follow a pernicious golden rule, doing unto the management as they would have the management, in their capacities as directors of other companies, do unto them. Thus, decisions may be too readily rubber-stamped, approved without the necessary critical mindset. Norms of deferring to management and approving generous compensation packages are created and entrenched. The kindred world-views mean that directors see the world from the same overall perspective as do the managers—this, too, can be a source of less-than-critical oversight over management’s decisions.

That directors are typically deferential to management, and see the world much as managers do, is a significant problem for corporate law. Corporate law’s principal doctrinal mantra for directors—abide by the duties of care and loyalty—has not done much to help. Carelessness (not giving enough attention to a decision) and traditionally conflicted transactions (putting the corporation’s money in one’s own pocket) are what these duties most directly address, but they are not what is at issue here. Emerging doctrine might be offering another approach. We argued in two earlier papers<sup>150</sup> that the

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149. See, e.g., Lucian Bebchuk, *Op-Ed., Congress Gets Punitive on Executive Pay*, WALL ST. J., Feb. 16, 2009, <http://online.wsj.com/article/SB123483031127995587.html>.

150. See *supra* note 3.



emerging category of “good faith,” characterized by the recent case of *Stone v. Ritter*<sup>151</sup> as part of the duty of loyalty, might provide a doctrinal home to this middle ground, establishing rules and standards to assess director conduct that shareholders might find problematic. Recent cases suggest the “home” may be none too hospitable to the types of problems we think need addressing. Still, these cases may not represent the final word.

Even if good faith comes to be developed more expansively, law on the books and as enforced cannot do all that is needed. It can address some of the most egregious cases where directors further their own interests at the expense of the corporation’s, but it cannot address the more commonplace cases in which directors are deferring too much to management. Delaware corporate law therefore needs, and has, a penumbra—a force influencing director behavior by means other than the imposition of liability or the threat thereof. When directors decide how to behave, they look to the law and the penumbra. They make a broader inquiry than that required to avoid liability, taking into account what judges favor, the (cautious) advice they receive from law firms, what various corporate communities favor, and so on. Extra-legal forces, particularly those marshaled when Delaware judges make statements other than those that create law, thus have significant weight.

We think that a great deal of problematic director behavior that is infeasible or undesirable to address through law on the books and as enforced can most feasibly be addressed through the penumbra. We think, as well, that the penumbra is broadening to encompass more of such behavior; the quote with which we started this Article provides an example. It is likely that the company was more chastened, and others were more affected, than would have been the case had the opinion been drier and stuck more closely to the doctrine’s application to the facts. Thus, we are optimistic that the penumbra will prove an important force in reigning in executive compensation so that it appropriately rewards performance that truly furthers the corporation’s long-term interests. We are optimistic, too, that the penumbra can complement the other forces making corporate governance more responsive to corporations’ true principals.

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151. 911 A.2d 362, 370 (Del. 2006).