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Sanitizing Interested Transactions

Claire Hill
University of Minnesota Law School, hillx445@umn.edu

Brett McDonnell
University of Minnesota Law School, bhm@umn.edu

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BY CLAIRE HILL & BRETT MCDONNELL*

ABSTRACT

How should corporate law deal with a controlling person's entry into a transaction with the corporation she controls? How should corporate law deal with transactions or decisions where one or more board members are interested? In this Article, we argue that Delaware law could do a better job answering these questions than it presently does.

We propose a modest strengthening of judicial review of interested transactions. For transactions where one or more directors have a conflicting interest and defendants attempt to cleanse the transaction using approval by the disinterested directors, we propose that the defendants show that the approving disinterested directors exercised independent business judgment. Only when the defendants make this showing would the transaction receive the protection of the business judgment rule. For all transactions with a controlling shareholder, the Weinberger entire fairness framework should apply.

Since many duty of loyalty cases will be characterized as derivative actions, we would also revise the first prong of Aronson. We propose that if the plaintiff shows that at least one director is interested, demand is excused unless defendants show that the approving disinterested directors exercised independent business judgment and the plaintiffs cannot rebut that showing. If the plaintiffs can show that the transaction was with a controlling shareholder (as defined in the Weinberger line of cases), demand should be excused.

Our proposal is far from radical. Rather, it provides weaker oversight of interested transactions than the traditional common law approach, which simply deemed all interested transactions void. It fits well within the purview of current Delaware law, which applies procedural scrutiny when independent directors approve such a transaction. It balances the danger that shareholders will be abused by interested transactions with

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the danger of encouraging strike suits. Indeed, the fact that Delaware does not already follow a variant of this approach is somewhat surprising.

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I. INTRODUCTION

How should corporate law deal with a controlling person's entry into a transaction with the corporation she controls? How should corporate law deal with transactions or decisions in which one or more board members are interested? Law's answers to those questions have varied over time, across jurisdictions, and depending upon who the controlling or interested persons are and what the transaction or decision is.[1] We believe that the law has overshot the mark in its evolution. Initially, the law was too strict in its handling of such transactions or decisions (which, for convenience, we shall refer to in this Article as "interested transactions"), but it has become too lenient. In most circumstances, the law now provides only minimal scrutiny of interested transactions that have been approved by disinterested directors.[2] In this Article we argue for closer judicial scrutiny when directors have approved transactions with fellow directors or controlling shareholders.

Interested transactions can arise in many circumstances, including compensation of directors and top executives, management buyouts, and freezeouts of minority shareholders.[3] Those who control a corporation can use many different methods to transfer value to themselves.[4] It has long been argued that interested transactions require greater legal regulation than other

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[1]*See generally* STEPHEN A. BAINBRIDGE, CORPORATION LAW AND ECONOMICS 307-20 (2002).

[2]*Id.* at 311-12. In particular, courts apply the protections of the business judgment rule. *See* Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 363 (Del. 1993).

[3]*See generally* BAINBRIDGE, *supra* note 1, at 305-60.

[4]*See* Grover C. Brown et. al., *Director and Advisor Disinterestedness and Independence Under Delaware Law*, 23 DEL. J. CORP. L. 1157, 1163 (1998) (citing MODEL BUS. CORP. ACT § 8.60 (1990) (Intro. Cmt.); *see also* Mary Siegel, *Fiduciary Duty Myths in Close Corporate Law*, 29 DEL. J. CORP. L. 377, 383-84 (2004).

corporate decisions because of the obvious incentives for controllers to shift value to themselves.[5] Of course, markets and contractual arrangements may anticipate and respond to the problem as well, lessening the need for regulatory responses. And yet, if contemporary American corporate law is to have any bite at all, fiduciary duty limits on interested transactions are surely the place to look for evidence of teeth marks.

Although we in passing consider other states, we mainly focus on Delaware's law, since Delaware is the dominant jurisdiction for American public corporations (and since this Article is written for a symposium on Delaware law). In Delaware, courts provide significant scrutiny of interested transactions in at least one context: where a controlling shareholder forces out the remaining minority shareholders.[6] Beyond that context, their scrutiny is much more limited, though the law is not utterly clear. It appears that approval by informed disinterested directors will cleanse most other interested transactions, with such approval subject only to the business judgment standard of review.[7] Defendants do not even need to show that the approving directors were independent of the influence of those who had an interest in the transaction.[8]

We propose a modest strengthening of judicial review of interested transactions. For transactions in which one or more directors have a conflicting interest and defendants attempt to cleanse the transaction using approval by the disinterested directors, we would require defendants to first show that the approving disinterested directors were informed and exercised independent business judgment. Only if the defendants can make this showing would the transaction receive the protection of the business judgment rule. For all transactions with a controlling shareholder, the *Weinberger*[9] entire fairness framework should apply.[10]

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[5]Harold Marsh, Jr., *Are Directors Trustees? Conflict-of-Interest and Corporate Morality*, 22 BUS. LAW. 35, 36 (1966) ("There have been several different rules adopted by courts and legislatures to deal with this problem of conflict of interest.").

[6]Peter V. Letsou & Steven M. Haas, *The Dilemma That Should Never Have Been: Minority Freeze Outs in Delaware*, 61 BUS. LAW. 25, 26 (2005) ("The Delaware courts have long reviewed minority shareholder challenges to such pre-approved freeze outs under the exacting 'entire fairness' standard.").

[7]Marciano v. Nakash, 535 A.2d 400, 405 n.3 (Del. 1987) ("[A]pproval by fully-informed disinterested directors under section 144(a)(1), or disinterested stockholders under section 144(a)(2), permits invocation of the business judgment rule and limits judicial review to issues of gift or waste with the burden of proof upon the party attacking the transaction.").

[8]*See infra* notes 69-73 and accompanying text. It is possible, though, that if plaintiffs can show that the approving disinterested directors lacked independence, the cleansing effect of board approval will disappear. Delaware law on this point is unclear.

[9]Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983).

[10]*See infra* notes 121 through 131 and accompanying text.

Since many duty of loyalty cases will be characterized as derivative actions, we must also address the *Aronson*[11] framework for determining whether demand is excused.[12] That framework currently embodies too strong a presumption that a majority of disinterested directors can be trusted to approve an interested transaction. We would revise the first prong of *Aronson* as follows: if plaintiff can show that at least one director was interested, demand is excused unless (1) defendants can show that the approving disinterested directors exercised independent business judgment, and (2) plaintiffs cannot rebut that showing. If plaintiffs can show that the transaction was with a controlling shareholder, demand should be excused.

Our proposal is far from radical. It provides weaker oversight of interested transactions than the traditional common law approach, which simply deemed all interested transactions void.[13] It fits well with the focus of current Delaware law on procedural scrutiny of approval by independent directors. It balances the danger that shareholders will be abused by interested transactions with the danger of encouraging strike suits.[14] Indeed, that Delaware does not already follow a variant of this approach is somewhat surprising.

Our argument proceeds as follows. In Part II, we survey the existing law of interested transactions, particularly transactions with interested directors. We briefly consider the approaches of the Model Business Corporation Act[15] ("MBCA") and the American Law Institute's ("ALI's") Principles of Corporate Governance,[16] but focus mainly on Delaware. Delaware law is not completely clear, but it can fairly be characterized as providing, in most circumstances, for business judgment review of

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[11]Aronson v. Lewis, 473 A.2d 805 (Del. 1984).

[12]Brehm v. Eisner, 746 A.2d 244, 256 (Del. 2000) ("The test of demand futility is a two-fold test under *Aronson* and its progeny. The first prong of the futility rubric is 'whether, under the particularized facts alleged, a reasonable doubt is created that . . . the directors are disinterested and independent.' The second prong is whether the pleading creates a reasonable doubt that the 'challenged transaction was otherwise the product of a valid exercise of business judgment.'") (quoting *Aronson*, 473 A.2d at 814).

[13]BAINBRIDGE, *supra* note 1, at 308 ("At early common law, conflicted interest transactions were *per se* voidable by the corporation without regard to whether they were fair to the corporation or had been approved by the board or shareholders, or so most authorities opine.").

[14]*See* Andrew C.W. Lund, *Rethinking* Aronson*: Board Authority and Overdelegation*, 11 U. PA. J. BUS. L. 703, 714 (2009) ("[I]n addition to protecting board authority, the demand requirement also serves to filter out strike suits.").

[15]MODEL BUS. CORP. ACT (2005).

[16]1 AM. LAW INST., PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS (1994).

transactions approved by informed disinterested (but not necessarily independent) directors.[17]

In Part III, we contrast that law with the law applicable in two particular types of cases where Delaware courts more closely scrutinize the behavior of directors. One is the *Weinberger* framework, applicable for controlling shareholder freezeouts.[18] Courts have articulated strong procedural guidelines for showing director independence, and even then, apply some substantive scrutiny, using the entire fairness standard. The other is the *Zapata*[19] framework for reviewing special litigation committee recommendations to dismiss derivative suits. We argue that while these two types of cases require closer judicial scrutiny than other sorts of interested transactions, the differences in the chances of bias and misbehavior are not as great as the differences in judicial treatment.[20] We therefore think that other sorts of interested transactions should receive greater scrutiny than they presently do.

Part IV presents our approach to how Delaware courts should review all interested transactions cleansed by disinterested director approval. The analysis begins with a closer look at the concept of independence. It discusses why independence is considered desirable—what it is intended to achieve, and how it might do so. It argues that Delaware's approach does a good job, but that it could do a far better one. In the subset of cases in which Delaware shifts the burden to defendants to show independence,[21] and makes that burden fairly difficult to meet, the approach works well. The rationale Delaware courts give for that approach applies more generally to cases where Delaware keeps the burden with the plaintiffs. We think the law should shift the burden in *all* cases where the rationale applies. In Part V, we apply our approach to several important recurring situations, including management buy-outs ("MBOs" or "MBO transactions"), executive compensation, and controlling shareholder transactions other than freezeouts. Part VI concludes.

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[17]Marciano v. Nakash, 535 A.2d 400, 405 (Del. 1987).

[18]*See generally* Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983).

[19]Zapata Corp. v. Maldonado, 430 A.2d 779 (Del. 1980).

[20]Julian Velasco makes a somewhat related argument. *See* Julian Velasco, *Structural Bias and the Need for Substantive Review*, 82 WASH. U. L.Q. 821, 851 (2004) ("*Zapata* is thus quite similar to *Unocal*. In each case, directors needed leeway to act in the interests of shareholders but could not be trusted completely to do so. The root of the problem is structural bias, and it demands a comprehensive solution. There is no good reason to have one special rule for hostile takeovers and another special rule for derivative litigation.").

[21]*See* Kahn v. Lynch Commc'n Sys., Inc., 638 A.2d 1110, 1116 (Del. 1994); *Weinberger*, 457 A.2d at 710.

II. PAST & PRESENT LAW OF INTERESTED TRANSACTIONS

Historically, corporate law fiduciary duties have come in two main variants: the duty of loyalty and the duty of care.[22] The duty of loyalty traditionally focused on interested transactions in which a director, officer, or controlling shareholder has a material stake in a transaction which is at odds with the interests of the corporation.[23] The duty of care requires directors to be adequately informed in making all corporate decisions.[24]

Duty of care cases rarely yield personal liability for directors because of the protections that the deferential business judgment rule offers.[25] Loyalty cases provide more hope for plaintiffs. The Delaware Supreme Court has recently expanded the concept of loyalty beyond interested transactions involving material financial conflicts.[26] However, in this Article we are only concerned with the narrower category of traditional loyalty cases involving self-dealing.[27] The law has long treated self-dealing with suspicion.[28] The reasons for that suspicion are obvious: If the leading decisionmakers, or those with strong influence over such decisionmakers,

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[22]*See* Stone *ex rel.* AmSouth Bancorporation v. Ritter, 911 A.2d 362, 370 (Del. 2006) ("[A]lthough good faith may be described colloquially as part of a 'triad' of fiduciary duties that includes the duties of care and loyalty, the obligation to act in good faith does not establish an independent fiduciary duty that stands on the same footing as the duties of care and loyalty.") (citing Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 361 (Del.1993)).

[23]*Technicolor*, 634 A.2d at 361-62 ("[T]he duty of loyalty mandates that the best interest of the corporation and its shareholders takes precedence over any interest possessed by a . . . [fiduciary which is] not shared by the stockholders generally . . . [and is implicated when] a director appearing on both sides of a transaction or a director receiving a personal benefit from a transaction not received by the shareholders generally.").

[24]Sean J. Griffith, *Good Faith Business Judgment: A Theory of Rhetoric in Corporate Law Jurisprudence*, 55 DUKE L.J. 1, 10 (2005) ("[T]he duty of care . . . requires simply that directors in control of the corporate enterprise exercise the same level of care that would be expected of ordinarily prudent persons in the conduct of their own affairs.").

[25]Waivers of liability under DEL. CODE ANN. tit. 8, § 102(b)(7) and Directors' & Officers' insurance also protect directors from personal liability for duty of care violations. On the extremely long odds of directors being held personally liable except in the case of interested transactions, see Bernard Black, Brian Cheffins & Michael Klausner, *Outside Director Liability*, 58 STAN. L. REV. 1055 (2006).

[26]*Stone*, 911 A.2d at 370. Indeed, there have always been cases that were neither care cases nor traditional loyalty cases; the courts have not always precisely specified, for instance, where cases involving takeovers fit in the taxonomy, sometimes using care language and sometimes using loyalty (and good faith) language. Analytically, though, takeover cases must largely fall within loyalty, and especially, loyalty as broadened in *Stone* to include good faith.

[27]We have considered the broader category of loyalty cases elsewhere. *See* Claire A. Hill & Brett H. McDonnell, Stone v. Ritter *and the Expanding Duty of Loyalty*, 76 FORDHAM L. REV. 1769 (2007) [hereinafter *Expanding Duty of Loyalty*]; Claire A. Hill & Brett H. McDonnell, *Disney, Good Faith, and Structural Bias*, 32 J. CORP. L. 833 (2007) [hereinafter *Structural Bias*].

[28]BAINBRIDGE, *supra* note 1, at 306-07.

can gain personally by making a decision that hurts the corporation, they may make decisions that benefit them at the corporation's expense.[29] If the gains from self-dealing are large, even market penalties may not be enough to discourage such behavior.

This presumably explains why at traditional common law, interested transactions were void and could not be remedied.[30] However, that approach proved too rigid.[31] In some cases, interested transactions can be good for the corporation.[32] Moreover, some conflicts are unavoidable—officers and directors must be paid, after all, and setting that pay poses an inevitable conflict.[33] Other conflicts are avoidable, but the corporation's interests are better served by not avoiding them.[34] For instance, sometimes insiders may be willing to enter into transactions with the corporation on better terms than outsiders, either because the insiders have information about the benefits of the transaction which cannot be credibly communicated, or because insiders trust that the corporation will not act in a way that hurts them.[35] A blanket prohibition on self-dealing would prevent too many valuable transactions from occurring.[36]

If we are going to allow self-dealing to occur, under what circumstances should we do so? We need to allow one or more decisionmakers to review and approve interested transactions. Three main options present themselves: courts, shareholders, and directors. Each option presents advantages and disadvantages. Each figures importantly in how the duty of loyalty has evolved.

Courts first imposed themselves as reviewers when they began to loosen the old rule of *per se* invalidity.[37] Courts began to allow self-dealing where defendants could prove that the transaction was fair to the corporation.[38] The fairness standard, at least as initially conceived, required a searching inquiry by the court into both the substantive terms of the deal

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[29] *See supra* note 4 and accompanying text.

[30] Marsh, *supra* note 5, at 35-39. There is some dispute over this characterization of the traditional common law. Norwood P. Beveridge, Jr., *The Corporate Director's Fiduciary Duty of Loyalty: Understanding the Self Interested Director Transaction*, 41 DEPAUL L. REV. 655, 659 (1992).

[31] BAINBRIDGE, *supra* note 1, at 308 (discussing the reasons the rule articulated at common law was too rigid).

[32] *Id.*

[33] *Id.* at 320-21.

[34] *Id.* at 308.

[35] BAINBRIDGE, *supra* note 1, at 308.

[36] *Id.*

[37] *See* Marsh, *supra* note 5, at 39-43.

[38] *Id.* at 43-46.

and the process by which it came about.[39] The corporation needed to convince the court that the result was at least as good as what the company could have obtained through arms-length bargaining with an outside party.

Eventually the law evolved to provide further options for cleansing self-dealing transactions. States adopted statutes that provide three different ways by which interested transactions could survive a legal challenge:[40] (1) Defendants can show the transaction is entirely fair to the corporation[41] (this repeats the approach that had developed within the common law); (2) Disinterested shareholders may approve the transaction;[42] or (3) Disinterested directors may approve the transaction.[43] In the case of shareholder or board approval, the approving body must have received full disclosure of material facts relevant to their decision.[44]

For shareholder and board approval to cleanse an interested transaction, there are several critical questions. Which shareholders or directors should be able to vote? What process should they follow in approving the transaction? What scrutiny, if any, should courts give to the decision to approve a self-dealing transaction? In this Article, we are concerned with the answers to these questions about appropriate procedure and standard of review in the context of director approval.[45] The answers have varied over time, and continue to vary across jurisdictions and within jurisdictions depending upon the nature of the transaction in question.

Jurisdictions agree that the directors whose approval counts must be disinterested. The statutes may or may not further require that the approving directors be independent of those who have an interest in the transaction. Critically, independence is not the same thing as disinterest.[46] Disinterested directors are those who do not have a personal financial stake in the transaction at issue. Consistent with its typical practice, Delaware articulates a definition at a fairly abstract and vague level, and then fills in details through a case-by-case inquiry.[47] In contrast, the MBCA and the ALI's

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[39]*See generally* Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983).

[40]DEL. CODE ANN. tit. 8, § 144 (West 2001); MODEL BUS. CORP. ACT Subchapter F.

[41]DEL. CODE ANN. tit. 8, § 144(a)(1); MODEL BUS. CORP. ACT § 8.61 (b)(3) (2005).

[42]DEL. CODE ANN. tit. 8, § 144(a)(2); MODEL BUS. CORP. ACT § 8.62.

[43]DEL. CODE ANN. tit. 8, § 144(a)(3); MODEL BUS. CORP. ACT § 8.63.

[44]Lynch v. Vickers Energy Corp., 383 A.2d 278, 281 (Del. 1977).

[45]Though beyond the scope of this Article, shareholder approval is also important, albeit probably less commonly used than board approval.

[46]*See, e.g.*, Rales v. Blasband, 634 A.2d 927, 936-37 (Del. 1993) (discussing the difference between "interest" and "independence").

[47]Donald C. Clarke, *Three Concepts of the Independent Director*, 32 DEL. J. CORP. L. 73, 105 (2007) ("The Delaware judiciary has on several occasions stressed the preferability of a case-by-case analysis . . . .").

Principles of Corporate Governance spell out a formal definition in somewhat more detail.[48]

That difference also appears in how different jurisdictions handle the concept of independence. In Delaware, the core notion is that directors must be able to exercise their own independent judgment in approving a transaction.[49] If they have a relationship with someone else that would cause their independence to be impaired, they are not independent.[50] The inquiry is highly fact-dependent.[51] However, in most contexts Delaware courts have been unwilling to infer a lack of independence unless the interested party is able to inflict a material financial punishment upon the director. Social ties, even close ones, have generally (though not quite always) not been enough.[52] A major concern of this Article is why that is so, and whether it is justified.

Independence is defined quite differently in stock exchange listing rules and federal securities law.[53] Independence is defined *ex ante* for a

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[48]*See* MODEL BUS. CORP. ACT § 8.60 (1) (2005) (defining a "director's conflicting interest"); 1 AM. LAW INST., PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 1.23 (2005) (defining "interested").

[49]*See* Clarke, *supra* note 47, at 102-08 (discussing the level of independence required under Delaware law).

[50]*See, e.g. In re* Oracle Corp. Deriv. Litig., 824 A.2d 917, 947 (Del. Ch. 2003) ("[The independence] inquiry recognizes that persons of integrity and reputation can be compromised in their ability to act without bias when they must make a decision adverse to others with whom they share material affiliations.").

[51]Beam *ex rel.* Martha Stewart Living Omnimedia, Inc. v. Stewart, 845 A.2d 1040, 1049 (Del. 2004) ("Independence is a fact-specific determination made in the context of a particular case.").

[52]*See Beam*, 845 A.2d at 1050 ("Allegations of mere personal friendship or a mere outside business relationship, standing alone, are insufficient to raise a reasonable doubt about a director's independence."); Leo E. Strine, Jr., *Derivative Impact: Some Early Reflections on the Corporation Law Implications of the Enron Debacle*, 57 BUS. LAW. 1371, 1378 (2002) ("As a general matter, the judiciary has been reluctant to conclude that non-economic relationships—such as close personal friendships—among outside directors and management compromise independence."). For an article defending the judiciary's general posture on this point, see E. Norman Veasey, *The Defining Tension in Corporate Governance in America*, 52 BUS. LAW. 393, 405-06 (1997) ("Friendship, golf companionship, and social relationships are not factors that necessarily negate independence. There is no place in corporate America today for empty formalities, adversarial boards, chilly boardroom atmospheres, timidity, or risk-averseness. Likewise, there is nothing to suggest that, on an issue of questioning the loyalty of the CEO, the bridge partner of the CEO cannot act independently as a director. To make a blanket argument otherwise would create a dubious presumption that the director would sell his or her soul for friendship."). E. Norman Veasey was the Chief Justice of the Delaware Supreme Court from 1992-2004. All of this being said, *Oracle* takes a different approach, looking carefully at social and other like ties.

[53]Clarke, *supra* note 47, at 84-99 (comparing the requirement for director independence under the New York Stock Exchange rules, NASDAQ rules, federal tax laws, and the Securities and Exchange Commission rules).

director generally, not *ex post* for particular transactions as in Delaware.[54] The MBCA does not use the term "independent directors." But, it does require that where an interested transaction is sought to be cleansed by director approval, that approval must be by "qualified directors."[55] A qualified director must not have "a familial, financial, professional, employment or other relationship that would reasonably be expected to impair the objectivity of the director's judgment when participating in the action to be taken."[56] (a definition quite close to Delaware's definition of independence).[57] The ALI's Principles of Corporate Governance speak of approval by "disinterested directors."[58] However, disinterest is defined broadly, and excludes directors who have:

> a business, financial, or familial relationship with a party to the transaction or conduct, and that relationship would reasonably be expected to affect the director's or officer's judgment with respect to the transaction or conduct in a manner adverse to the corporation; [or who are] . . . subject to a controlling influence by a party to the transaction or conduct or a person who has a material pecuniary interest in the transaction or conduct, and that controlling influence could reasonably be expected to affect the director's or officer's judgment with respect to the transaction or conduct in a manner adverse to the corporation.[59]

Thus, the ALI's definition of "disinterested director" resembles Delaware's definition of "independent director" and the MBCA's definition of "qualified director."

What effect does approval by disinterested directors have on a court's scrutiny of an interested transaction? Under the MBCA, if a transaction is approved by the *qualified directors* it receives business judgment review.[60] That "qualified" qualification is important—it imposes an independence requirement that is quite possibly lacking in Delaware. The ALI's Principles

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[54]Lisa M. Fairfax, *The Uneasy Case for the Inside Director*, 96 IOWA L. REV. 127, 134-35 (2010).

[55]MODEL BUS. CORP. ACT § 8.61(a) (2005).

[56]*Id. at* § 1.43(a)(3) & (b)(1).

[57]Aronson v. Lewis, 473 A.2d 805, 816 (Del. 1984) ("Independence means that a director's decision is based on the corporate merits of the subject before the board rather than extraneous considerations or influences.").

[58]1 AM. LAW INST., PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 5.02 (a)(2)(B) (2005).

[59]*Id. at* § 1.23 (a).

[60] MODEL BUS. CORP. ACT § 8.61(b) official cmt.

of Corporate Governance provide that the transaction must be approved by disinterested directors who "could reasonably have concluded that the transaction was fair to the corporation."[61] This standard is intended to be less deferential than business judgment and less searching than fairness review, reflecting the strength of the threats of bias in these situations.[62]

In Delaware, the standard of review for an interested transaction depends crucially upon whether or not a controlling shareholder has an interest in the transaction.[63] For this Part, we shall assume there is no controlling shareholder (or if there is, that shareholder has no conflicting interest in the transaction). We discuss the case of controlling shareholders in the next Part.

Somewhat surprisingly, the Delaware case law concerning the standard of review for board approval of transactions in which one or more director has a conflict is rather sparse and a bit confused. One line of cases, which we suspect best represents current Delaware law, states that the business judgment rule extends to conflicted transactions approved by the disinterested directors. This approach is stated in *dictum* in *Marciano*[64] and *Wheelabrator*,[65] and is stated and applied in *Benihana*.[66] Under the business judgment rule, the plaintiffs have the burden to show that the defendants did not act in good faith, were not adequately informed, or did not honestly believe they were acting in the best interests of the corporation.[67] This burden is extremely hard for plaintiffs to overcome; they rarely succeed in cases decided under the business judgment rule.[68]

Note a crucial fact: according to *Benihana*, *Wheelabrator*, and *Marciano*, to get the benefit of the business judgment standard, defendants

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[61]1 AM. LAW INST., PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 5.02 (a)(2)(B).

[62]*Id.* at § 5.02 (a)(2)(B) official cmt.

[63]Citron v. Fairchild Camera & Instrument Corp., 569 A.2d 53, 70 (Del. 1989) ("[A] shareholder who owns less than 50% of a corporation's outstanding stocks does not, without more, become a controlling shareholder of that corporation, with a concomitant fiduciary status. For a dominating relationship to exist in the absence of controlling stock ownership, a plaintiff must allege domination by a minority shareholder through actual control of corporate conduct.") (internal quotations and citation omitted). Note the negative implication of this quote—for shareholders who own more than fifty percent of the outstanding stock, there is no need to allege domination through actual control of conduct.

[64]Marciano v. Nakash, 535 A.2d 400, 405 n.3 (Del. 1987).

[65]*In re* Wheelabrator Techs., Inc. S'holder Litig., 663 A.2d 1194, 1205 n.8 (Del. Ch. 1995).

[66]Benihana of Tokyo, Inc. v. Benihana, Inc., 906 A.2d 114, 120 (Del. 2006).

[67]*Id.* at 120 (quoting Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984)).

[68]Black et al., *supra* note 25, at 1090-91 (discussing how in *Disney*, the plaintiff had surpassed mutiple hurdles only to fail in the face of the business judgment rule).

need only show that the *disinterested* directors approved the transaction.[69] Those directors must have been informed of all material facts concerning the conflict in order for their approval to have this cleansing effect.[70] The *Benihana* court does *not* ask whether or not the approving directors were *independent*, nor does Delaware's statute impose an independence requirement. Disinterested directors are thus presumed to be able to independently decide whether or not transactions in which one or more of their board colleagues are interested are in the corporation's best interests. There is little room for plaintiffs to challenge that presumption. They can claim that the approval is not in good faith, but as we shall see that is a huge hurdle to surmount.

Delaware is not at all clear on the role (or lack thereof) of independence, though. As we shall soon discuss, the first prong of the *Aronson* standard for judging demand utility speaks of both interest and lack of independence.[71] If plaintiffs have enough facts to adequately question either the interest or the lack of independence of a majority of the board, demand is excused.[72] Other cases say that if plaintiffs demonstrate that a majority of the board was interested or lacking in independence, the entire fairness standard of review applies.[73] If this is the rule in Delaware, it puts Delaware much closer to the MBCA and ALI, and closer to our preferred approach.[74] Note, though, that even under this tougher approach, the burden is on the plaintiff to show that a majority are interested or lack independence.

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[69]*Benihana*, 906 A.2d at 120 ("Section 144 of the [DGCL] provides a safe harbor for interested transactions, like this one, if '[t]he material facts as to the director's . . . relationship or interest and as to the contract or transaction are disclosed or are known to the board of directors . . . and the board . . . in good faith authorizes the contract or transaction by the affirmative votes of a majority of the disinterested directors . . . .' After approval by disinterested directors, courts review the interested transaction under the business judgment rule, which 'is a presumption that in making a business decision, the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interest of the company.'") (quoting DEL. CODE ANN. tit. 8, § 144(a)(1) (West 2001), and *Aronson*, 473 A.2d at 812) (citations omitted); *Wheelabrator*, 663 A.2d at 1205 n.8 ("[W]hen a majority of fully informed, disinterested directors (even if less than a quorum) approve a transaction in which other directors are interested, the transaction will not be void or voidable by reason of the conflict of interest.").

[70]*Benihana*, 906 A.2d at 120.

[71]*Aronson*, 473 A.2d at 814.

[72]*Id.*

[73]Orman v. Cullman, 794 A.2d 5, 22 (Del. Ch. 2002) ("To rebut successfully business judgment presumptions in this manner, thereby leading to the application of the entire fairness standard, a plaintiff must normally plead facts demonstrating 'that a majority of the director defendants have a financial interest in the transaction or were dominated or controlled by a materially interested director.'") (quoting Crescent/Mach I Partners, L.P. v. Turner, 846 A.2d 963, 979 (Del. Ch. 2000)) (emphasis omitted); *see also Aronson*, 473 A.2d at 815.

[74]*See supra* notes 62-68 and accompanying text.

Unsurprisingly, scholars have differed in their prescriptions for how much courts should defer to board approval of interested transactions.[75] Some have called for a return to fairness review for all interested transactions, focusing on the various factors which may cause directors to be unwilling to adequately police their colleagues.[76] Others have defended the status quo of business judgment review deference.[77] One article surveying a large amount of empirical evidence on the effect of outside director involvement in a variety of situations suggests that outside directors are effective monitors in some circumstances but not in others,[78] arguing that it is quite hard to generate a legal approach that adequately recognizes the nuance of the evidence.[79]

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[75] *See* Stephen M. Bainbridge, *Independent Directors and the ALI Corporate Governance Project*, 61 GEO. WASH. L. REV. 1034, 1083 (1993) (arguing that the ALI's attempt, through the Principles of Corporate Governance, is unlikely to capture momentum because "courts are likely to go on treating these issues on a case-by-case basis in which the critical question is whether the conduct of the independent board members is worthy of deference"); Charles Hansen, John F. Johnston & Frederick H. Alexander, *The Role of Disinterested Directors in "Conflict" Transactions: The ALI Corporate Governance Project and Existing Law*, 45 BUS. LAW. 2083, 2097-98 (1990) (arguing that the ALI's attempt to eviscerate the business judgment rule is counter to the policy reasons underlying the rule). *But see* Richard W. Holtz, *Interested Transactions by Corporate Directors: A Weakening of the Fiduciary Duty of Loyalty*, 28 SUFFOLK U. L. REV. 93, 120-21 (1994) ("A prevailing requirement of fairness . . . ensures that [conflict] transactions . . . [be] subject to immediate and strict judicial scrutiny. Such ready judicial scrutiny would check the danger of less demanding standards by guaranteeing a substantive inquiry regarding the nature of an interested transaction as opposed to an inquiry regarding only the procedures taken in effecting the transaction."); Note, *The Propriety of Judicial Deference to Corporate Boards of Directors*, 96 HARV. L. REV. 1894, 1913 (1983) ("Deference to board approval in conflict-ridden situations is clearly unjustifiable."); Blake Rohrbacher, John Mark Zeberkiewicz & Thomas A. Uebler, *Finding Safe Harbor: Clarifying the Limited Application of Section 144*, 33 DEL. J. CORP. L. 719, 746-47 (2008) (arguing that interpretation of DEL. CODE ANN. tit. 8, § 144 has been misguided because the "result has no basis in the statute itself; the legislative history surrounding the adoption thereof, and certain cases interpreting the statute, dispel such a proposition. Section 144 is extremely limited . . . [and] merely provides that a covered transaction will *not be voidable solely* as a result of the offending interest") (emphasis added).

[76] J. Robert Brown, Jr., *Disloyalty without Limits: "Independent" Directors and the Elimination of the Duty of Loyalty*, 95 KY. L.J. 53, 103-05 (2006) ("Neutrality is not a rote process of counting directors, with a majority the automatic tipping point. Neutrality is a process of ensuring the absence of the interested influence."); Melvin Aron Eisenberg, *Self-Interested Transactions in Corporate Law*, 13 J. CORP. L. 997, 1002-06 (1988); Victor Brudney, *The Independent Director—Heavenly City or Potemkin Village?*, 95 HARV. L. REV. 597, 602-17 (1982).

[77] BAINBRIDGE, *supra* note 1, at 253-69; Hansen et al., *supra* note 75, at 2097-98.

[78] *See generally* Laura Lin, *The Effectiveness of Outside Directors as a Corporate Governance Mechanism: Theories and Evidence*, 90 NW. U. L. REV. 898, 902 (1996).

[79] *Id.* at 902 (concluding that the article's empirical data is "mixed as to the effectiveness of outside directors as monitors . . . [and that] conditions exist under which outside directors appear to be effective and ineffective").

Interested director transactions can arise in various contexts. Consider two of particular importance, MBOs and executive compensation. MBOs involve a change in control, a context in which Delaware courts are sensitive to conflicts of interests and have devised a variety of heightened standards of review.[80] There are clear incentives and opportunities for managers to take advantage of shareholders in this context.[81] On the other hand, there is also a strong argument that MBO going-private transactions may strengthen managerial incentives to act in the corporation's interest, and hence should be encouraged.[82] In the late 1980s and early 1990s, there was fairly extensive normative and empirical discussion of MBOs, with unsurprisingly indeterminate conclusions.[83] That discussion died down along with MBOs themselves, but in the last few years MBOs have become a bit more common again, and there has been a little renewed scholarly attention. The empirical evidence as to how shareholders fare under MBOs remains ambiguous.[84]

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[80]*See* Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 180 (Del. 1986); Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954-55 (Del. 1985); Weinberger v. UOP, Inc., 457 A.2d 701, 710 (Del. 1983).

[81]*See Unocal*, 493 A.2d at 954 ("Because of the omnipresent specter that a board may be acting primarily in its own interests, rather than those of the corporation and its shareholders, there is an enhanced duty which calls for judicial examination at the threshold before the protections of the business judgment rule may be conferred.").

[82]*See, e.g.*, Dale Arthur Oesterle & Jon R. Norberg, *Management Buyouts: Creating or Appropriating Shareholder Wealth?*, 41 VAND. L. REV. 207, 222-34 (1988) (discussing six reasons why MBOs may motivate managers to act in the corporation's and shareholders' best interests).

[83]*Compare* Yakov Amihud, *Leveraged Management Buyouts and Shareholders' Wealth, in* LEVERAGED MANAGEMENT BUYOUTS: CAUSES AND CONSEQUENCES 3, 24 (Yakov Amihud ed., 1989) (concluding that MBOs increase shareholders' wealth by increasing stock prices), *with* Robert L. Kieschnick, Jr., *Management Buyouts of Public Corporations: An Analysis of Prior Characteristics, in* LEVERAGED MANAGEMENT BUYOUTS: CAUSES AND CONSEQUENCES 35, 57 (Yakov Amihud ed., 1989) (concluding that the benefit of MBOs cannot be established). *See generally* Richard A. Booth, *Management Buyouts, Shareholder Welfare, and the Limits of Fiduciary Duty*, 60 N.Y.U. L. REV. 630 (1985); Linda Elizabeth DeAngelo, *Accounting Numbers as Mark Valuation Substitutes: A Study of Management Buyouts of Public Stockholders*, 61 ACCT. REV. 400 (1986); Louis Lowenstein, *Management Buyouts*, 85 COLUM. L. REV. 730 (1985) (concluding that MBOs provide substantial gains for shareholders); Oesterle & Norberg, *supra* note 82.

[84]Kevin Amess, *The Effect of Management Buyouts on Firm-Level Technical Efficiency: Evidence from a Panel of U.K. Machinery and Equipment Manufacturers*, 51 J. IND. ECON. 35, 42 (2003); Kai Chen, Yong-Cheol Kim & Richard D. Marcus, *Hands in the Cookie Jar? The Case of Management Buyouts* 28 (2009), *available at* http://ssrn.com/abstract=1364655; Sridhar Gogineni & John Puthenpurackal, The Effects of Management Involvement on Takeover Competition and Shareholder Returns 31 (March 25, 2011) (unpublished manuscript), *available at* http://ssrn.com/abstract=1572971; John C. Coates, IV, An Empirical Reassessment of MBO Bids: Techniques, Outcomes, and Delaware Corporate *Law* (Oct. 18, 2005) (unpublished manuscript), *available at* http://www.law.columbia.edu/center_program/law_economics/wkshops/2005_FallTerm; Matthew D. Cain & Steven M. Davidoff, *Form Over Substance? The Value of Corporate Process and Management Buy-outs*, 36 DEL. J. CORP. L. 849, 861-71 (2012).

However, there is at least some good evidence that procedural safeguards—such as independent director committees, majority of the minority shareholder approval conditions, and contractual structures encouraging competitive bidding—help shareholders receive a better deal.[85]

How do the Delaware courts approach MBOs? MBOs in which management is tied to a controlling shareholder are covered by the *Weinberger*[86] framework, discussed in the next Part. Some MBOs may trigger the heightened scrutiny of the *Revlon*[87] standard, depending upon the nature of ownership before and after the transaction.[88] But what of MBOs that trigger neither *Weinberger* nor *Revlon*? What standard of review applies then? MBOs are inherently an interested transaction, but what if the transaction is approved by disinterested directors who are not a part of the buying group of managers? There is less case law on this than one might expect, even though it is an important question. In two cases from 1990, the Chancery Court applied different standards. The *Weinberger* entire fairness standard was applied for *In re Shoe-Town Inc. Stockholders Litigation*,[89] while the business judgment rule was applied in *Lewis v. Leaseway Transportation Corp.*,[90] even though in both cases there was no controlling shareholder and the transaction was approved by disinterested directors who composed a majority of the board.[91] It is hard to tell whether the cases can be distinguished—one possible ground for doing so is that the court determined in *Shoe-Town* that plaintiffs presented adequate evidence challenging the independence of the disinterested directors, while they did not do so in *Lewis*.[92] Thus, in these cases, unlike *Benihana*, there may be a role for independence, but the role is obscure. It is possible that courts will look to independence in the M&A context but not for other sorts of conflict transactions—we shall see this possibility for transactions with controlling

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[85]Cain & Davidoff, *supra* note 84, at 879-95.

[86]Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983).

[87]Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986).

[88]Stephen M. Bainbridge, Unocal *at 20: Director Primacy in Corporate Takeovers*, 31 DEL. J. CORP. L. 769, 802-03 (2006) (outlining three change of control scenarios whereby the *Revlon* standard is implicated).

[89]1990 WL 13475, at *3-*7 (Del. Ch. Feb. 12, 1990), *reprinted in* 16 DEL. J. CORP. L. 404, 411-17 (1990).

[90]1990 WL 67383, at *4-*8 (Del. Ch. May 16, 1990), *reprinted in* 16 DEL. J. CORP. L. 815, 824-28 (1990).

[91]*See Shoe-Town*, 1990 WL 13475, at *1-*2, 16 DEL. J. CORP. L. at 409-10; *Lewis*, 1990 WL 67383, at *4-*5, 16 DEL. J. CORP. L. at 824-25.

[92]*See Shoe-Town*, 1990 WL 13475, at *1-*2, 16 DEL. J. CORP. L. at 409-10; *Lewis*, 1990 WL 67383, at *4-*5, 16 DEL. J. CORP. L. at 824-25.

shareholders as well. *Wheelabrator* is also close to the MBO context.[93] In that case, a shareholder went from twenty-two to fifty-five percent ownership in the scrutinized transaction, and four of the nine directors were designees of the shareholder.[94] In *dictum*, the court held that business judgment review would apply to approval by the disinterested directors.[95]

Executive compensation, where the executive is a director (including a director who is also an officer) is an interested transaction that occurs in every corporation. As with MBOs, the normative and empirical arguments over executive compensation are inconclusive, although the literature for executive compensation is much more extensive.[96] Some believe that most executive compensation contracts represent optimal responses to the need to provide appropriate incentives for managers.[97] Others believe that much executive compensation reflects undue influence exerted by managers with power over their boards.[98] These two approaches obviously differ in their implications for how much legal regulation of executive compensation is needed.

The leading recent Delaware case on executive compensation is of course *Disney*.[99] Ultimately in that case the court held that the conflict did not involve a director, since the person with the conflict, Michael Ovitz, was not a director at the time of initial approval of his contract, and he was not involved in the decision as to whether he would be fired.[100] The latter holding strikes us as wrong—Ovitz was a director at the time the decision to fire him was made and he had a clear conflict.[101] The fact that he was not

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[93] *In re* Wheelabrator Techs., Inc. S'holders Litig., 663 A.2d 1194 (Del. Ch. 1995).

[94] *Id.* at 1197-98.

[95] *Id.* at 1205.

[96] *See* David I. Walker, *The Law and Economics of Executive Compensation: Theory and Evidence*, *in* RESEARCH HANDBOOK ON THE ECONOMICS OF CORPORATE LAW (Claire A. Hill & Brett H. McDonnell, eds.) (forthcoming 2012).

[97] *See, e.g.*, John E. Core, Wayne R. Guay & David F. Larcker, *Executive Equity Compensation and Incentives: A Survey*, 9 FRBNY ECON. POL'Y REV. 27, 33 (Apr. 2003); Kevin J. Murphy & Ján Zábojník, *CEO Pay and Appointments: A Market-Based Explanation for Recent Trends*, 94 AM. ECON. REV. 192, 195 (2004).

[98] *See generally* LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION (2004); J. Robert Brown, Jr., *Returning Fairness to Executive Compensation*, 84 N.D. L. REV. 1141 (2008); Claire A. Hill & Brett H. McDonnell, *Executive Compensation and the Optimal Penumbra of Delaware Corporation Law*, 4 VA. L. & BUS. REV. 333 (2009).

[99] *In re* Walt Disney Co. Deriv. Litig., 906 A.2d 27 (Del. 2006).

[100] *Id.* at 49.

[101] *Id.* ("Ovitz did possess fiduciary duties as a director and officer while these decisions were made, but by not improperly interjecting himself into the corporation's decisionmaking process nor manipulating that process, he did not breach the fiduciary duties he possessed in that unique circumstance.") (quoting Chancellor Chandler's findings in the post-trial opinion).

involved in the decision does not mean there was no conflict. An interested transaction should not be able to be cleansed simply by having the interested directors not participate in approving the transaction, although that is surely one valuable procedural protection that should favor the board in making its case to a court. Indeed, the fact that simple business judgment review[102] is applied to the decision to fire Ovitz and pay him his contractual severance is, along with *Benihana*, another important statement of the current Delaware position that interested director transactions get business judgment review following approval by informed disinterested directors.[103]

The court does look closely at whether the disinterested directors approved the transactions with Ovitz in good faith.[104] This involves some real scrutiny of the procedure followed in approving his contract and then his dismissal.[105] However, the plaintiffs have the burden of demonstrating bad faith, and there is no close scrutiny of the independence of the approving directors.[106] The standard for showing bad faith is also quite difficult to meet—plaintiffs must show that the Board had "a conscious disregard [for its] duties."[107] More recently, the Delaware Supreme Court has given this a strict gloss: "Only if [the directors] knowingly and completely failed to undertake their responsibilities would they breach their duty of loyalty."[108]

Thus, the basic approach in Delaware to transactions involving interested directors which have been approved by the disinterested directors following adequate disclosure is to apply business judgment rule review to the decision. However, to fully understand the law and how it applies in litigation, we must also consider a crucial procedural limitation that will apply for many loyalty cases which are characterized as derivative causes of action.[109] For such cases, in order to proceed, plaintiffs, in their complaints, must show that demand upon the board should be excused. To do so, they must plead particularized facts which create reasonable doubt either that a

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[102]This being said, in *Stone v. Ritter* the Court later held that action in bad faith is disloyal. Stone v. Ritter, 911 A.2d 362, 370 (Del. 2006). Still, the burden is on the plaintiffs to prove bad faith, just as it is under the business judgment rule. *See* Hill & McDonnell, *Expanding Duty of Loyalty*, *supra* note 27, at 1773 (quoting Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 361 (Del. 1993)).

[103]*See supra* notes 40-63 and accompanying text.

[104]*See Disney*, 906 A.2d at 62-68.

[105]*See id.*

[106]*Id.* at 52. *But see* Brehm v. Eisner, 746 A.2d 244, 256-57 (Del. 2000) (suggesting that director independence is indeed relevant in such a calculus).

[107]*Disney*, 906 A.2d at 67.

[108]Lyondell Chem. Co. v. Ryan, 970 A.2d 235, 243-44 (Del. 2009).

[109]For a discussion of derivative claims, see Tooley v. Donaldson, Lufkin & Jenrette, Inc., 845 A.2d 1031, 1036 (Del. 2004).

majority of the board was disinterested or independent, or that the transaction was otherwise a proper exercise of business judgment.[110]

This *Aronson* standard presents a further tough barrier to plaintiffs in transactions where only a minority of the board has a conflicting interest. In such cases, the plaintiffs must show that total number of directors who are either lacking in independence or interested constitutes a majority of the board.[111] Here, interestingly, the courts are asking about director independence, which we have seen they largely do not do when applying the standard of review following a demonstration that the disinterested directors approved the transaction.[112] But, the courts make it very difficult for plaintiffs to show a lack of independence at the pleading stage.

The poster child for this difficulty is *Beam v. Stewart*.[113] The case involved a claim that Martha Stewart violated her duty of loyalty to Martha Stewart Omnimedia.[114] For purposes of the complaint, Stewart herself was presumed interested.[115] The opinion contains an elaborate discussion of the personal ties between Stewart and various directors and what those ties imply for independence.[116] We shall have more to say about this discussion in Part IV. For here, we focus on a simpler point: The court brushes aside with very little discussion the fact that Martha Stewart was the ninety-four percent shareholder. Of *Martha Stewart* Omnimedia.[117] This apparently is not enough to call the independent judgment of the other directors into question.

That was a correct application of the law since *Aronson*. But as we shall see, it is in great tension with how the courts handle cases involving transactions with controlling shareholders in the M&A context (which

[110]Aronson v. Lewis, 473 A.2d 805, 815 (Del. 1984); *see also Brehm*, 746 A.2d at 254 ("[T]hose pleadings must comply with stringent requirements of factual particularity that differ substantially from the permissive notice pleadings.").

[111]*In re* Walt Disney Co. Deriv. Litig., 731 A.2d 342, 354 (Del. Ch. 1998), *aff'd in part, rev'd in part sub nom. Brehm*, 746 A.2d at 267.

[112]*See supra* notes 69-79 and accompanying text.

[113]Beam *ex rel.* Martha Stewart Living Omnimedia, Inc. v. Stewart, 845 A.2d 1040 (Del. 2004).

[114]*Id.* at 1044.

[115]*Id.* at 1044-45. The matters at issue in the case clearly do not present a typical "interested transaction." The behavior that would have grounded the complaint was questionable stock trading, behavior that was antithetical to Stewart's image. An argument exists that the shareholders had a stake in Stewart not tarnishing her image, since Stewart's products were not sold just for their inherent quality; rather, her image was a prominent part of the sales pitch. We take no position as to whether shareholders had any cause for a lawsuit; this Article principally addresses paradigmatic interested transactions.

[116]*Beam*, 845 A.2d at 1045-46.

[117]*Id.* at 1054.

typically arise as direct causes, and hence are not subject to the *Aronson* roadblock). In those cases, if plaintiffs show the transaction is with a controlling shareholder—and anyone with a majority of shares, much less ninety-four percent, is presumptively controlling—the transaction is automatically subject to fairness review.[118] The defendants may nonetheless show that the remaining directors were independent enough that their approval may shift the burden of proof, but only if quite-careful procedure is followed, and even then, the standard remains entire fairness.[119] The intense scrutiny of controlling shareholder interested transactions in such cases is in stark contrast with the court's quick dismissal in *Beam*.[120] If it is this difficult to show a lack of independence for purposes of surviving an *Aronson* motion to dismiss where there is a ninety-four percent controlling shareholder (where, after all, courts have sometimes acknowledged real scrutiny is needed), how much more difficult is it to survive a motion to dismiss where the conflict involves directors who are not controlling shareholders?

Thus, in transactions involving interested directors but not controlling shareholders, the case is quite likely to be dismissed on the pleadings if it is characterized as a derivative action and only a minority of directors had a conflict. If a majority was conflicted or it is a direct action, the case may survive somewhat longer. However, once defendants can show that a majority of the informed disinterested directors approved the transaction, they will be entitled to the highly deferential business judgment standard of review. Defeat for plaintiffs should follow soon thereafter, although plaintiffs may be able to prolong the case for a while if they can make credible allegations about a lack of good faith.

III. CONTRAST WITH *WEINBERGER* AND *ZAPATA*

We see that Delaware courts are quite willing to trust the decision of disinterested directors to approve transactions with other directors. But they are not always so trusting. In some circumstances they believe that disinterested director approval is likely enough to be tainted that they apply much more searching scrutiny. We consider two such contexts here: controlling shareholder freezeouts and special litigation committee recommendations to dismiss a derivative case. We analyze the scrutiny that

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[118] Orman v. Cullman, 794 A.2d 5, 20 n.36 (Del. Ch. 2002).

[119] *Id.* at 20.

[120] *Compare* Kahn v. Lynch Commc'n Sys., Inc., 638 A.2d 1110, 1114-15 (Del. 1994) (noting that the burden never shifted from minority shareholder who was deemed to have controlled the actions of the board), *with Beam*, 845 A.2d at 1054.

courts impose in those contexts, and then argue that while somewhat different scrutiny may be appropriate for these cases as opposed to other sorts of interested transactions, there are enough similarities that the judicial standards should not diverge as widely as they do.

One quite important context involves controlling shareholder freezeouts. In these, a controlling shareholder uses its power over the board and its own votes to buy up the remaining minority shares.[121] If the controlling shareholder has enough votes on its own, the minority shareholders can be forced into these transactions without their approval.[122] There is obvious potential for abuse, and courts have accordingly policed freezeouts far more carefully than most corporate actions.[123]

What happens when defendants try to use disinterested director approval to cleanse such freezeouts? Delaware courts apply the *Weinberger* framework.[124] The court first looks to whether the acquirer is a controlling shareholder.[125] If the shareholder owns over fifty percent of the voting rights, that is presumptive control.[126] If the ownership is below fifty percent, but not too far below, the court does a fact-intensive inquiry to determine whether the shareholder had effective control over the board.[127]

If the acquisition is by a controlling shareholder, then the entire fairness standard applies. That is, the defendants have the burden to show that the transaction reflects a fair price (the substantive terms are those to be expected from arms-length bargaining with a third party) and it was reached through fair dealing (the procedure followed was fair).[128] Defendants can improve their chances by establishing a special committee of disinterested and independent directors which appoints independent advisors, obtains a

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[121]Guhan Subramanian, *Fixing Freezeouts*, 115 YALE L.J. 2, 9 (2005); Robert B. Thompson & Randall S. Thomas, *The New Look of Shareholder Litigation: Acquisition-Oriented Class Actions*, 57 VAND. L. REV. 133, 146 (2004).

[122]Thompson & Thomas, *supra* note 121, at 146 ("When a shareholder with more than 50 percent voting power forces through a merger in order to cash out the minority shareholders, these minority shareholders are powerless to stop the transaction.").

[123]*See* Thompson & Thomas, *supra* note 121, at 139 ("Viewed from a broader perspective, shareholder acquisition litigation polices those management transactions with the highest potential for self-dealing.").

[124]*See generally* Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983).

[125]BAINBRIDGE, *supra* note 1, at 337 ("Under Delaware law, a shareholder is deemed to have control if the shareholder either owns a majority of the voting stock or exercises control over corporate decisionmaking.") (citing Ivanhoe Partners v. Newmont Mining Corp., 535 A.2d 1334, 1344 (Del. 1987)).

[126]*Id.* at 337 ("If the shareholder owns less than 50 percent of the voting stock, plaintiff must show evidence of actual control of corporate conduct.") (citations omitted).

[127]*See supra* note 63 and accompanying text.

[128]*Weinberger*, 457 A.2d at 711.

fairness opinion from its financial advisors, and bargains actively on behalf of the corporation.[129] But a court will look closely at the procedure followed in establishing this committee and then in striking the deal, and even if the court concludes the procedure was adequate, the only effect is to shift the burden to the plaintiffs to prove the transaction was unfair.[130]

Compare this relatively intense scrutiny with what we find outside the context of a controlling shareholder acquisition. The *Weinberger* test for a controlling shareholder imposes fairness review much more readily than the *Aronson/Beam* independence inquiry will allow demand to be excused for derivative actions involving even the most blatantly dominant of shareholders. There is a serious disjunction here. Once *Weinberger* applies, the court conducts a serious inquiry into the relationship between the approving directors and the controlling shareholder and the procedures followed in negotiating and approving the acquisition, and at least some real inquiry into the substance of the deal as well.[131] None of this occurs for interested director transactions that get business judgment review.

The case law raises some important questions for transactions with controlling shareholders. Even for controlling shareholder freezeouts, the controller may be able to avoid fairness review if it first buys out minority shareholders to reach a ninety percent threshold and then buys the remaining shares in a short-form merger.[132] Several cases at one point suggested that such a procedure would be reviewed only for coercion and then under the business judgment rule,[133] although later cases suggest that fairness review applies unless the transaction gets both independent director approval (which is closely scrutinized) *and* approval by a majority of the minority shareholders.[134] It remains unclear which is the correct approach under Delaware law.[135]

Of greater direct interest for this Article, it is somewhat unclear whether the *Weinberger* entire fairness framework applies only to freezeout acquisitions, or whether it applies to all transactions in which a shareholder

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[129]*See* Kahn v. Lynch Commc'n Sys., Inc., 638 A.2d 1110, 1117 (Del. 1994).

[130]*Id.*

[131]*See Weinberger*, 457 A.2d at 712.

[132]Subramanian, *supra* note 121, at 20-21 ("Thus, with *Glassman*, the other shoe had dropped, and practitioners now had a blueprint for avoiding entire fairness review in a freezeout transaction. Under *Siliconix*, a tender offer to the minority would be exempt from entire fairness review, and if the controller got to 90% voting control, the back-end short-form merger would also be exempt under *Glassman*.").

[133]*See, e.g.*, *In re* Siliconix Inc. S'holders Litig., 2001 WL 716787, at *6 (Del. Ch. June 19, 2001), *reprinted in* 27 DEL. J. CORP. L. 1011, 1021 (2002).

[134]*In re* Cox Commc'ns, Inc. S'holders Litig., 879 A.2d 604, 643-44 (Del. Ch. 2005).

[135]*See In re* CNX Gas Corp. S'holders Litig., 4 A.3d 397, 406-14 (Del. Ch. 2010).

has a controlling interest. The rule as announced in *Weinberger* does not limit itself to the freezeout context. Nor is there a compelling policy reason to so limit it—controlling shareholders can take advantage of minority shareholders in many ways, and can do so just as effectively and profitably without acquiring a further equity stake.[136] They may loot a corporation by buying its assets at fire sale prices, or simply by paying out all the company's cash to themselves as executive compensation, for instance.[137] But so far *Weinberger* has been applied mainly if not exclusively in the freezeout merger context, and cases like *Beam* would certainly make the fairness framework hard to apply in the context of a derivative action. The applicability of *Weinberger* outside of the freezeout context is an open and important question, which we address in our proposal below.

Why such different approaches depending upon the presence or absence of a controlling shareholder? The stricter scrutiny where a controlling shareholder is present reflects a concern with structural bias.[138] A controlling shareholder by definition has the power to appoint and remove directors at will, without the agreement of other shareholders.[139] Given such power, the directors appointed by that shareholder, facing the prospect of removal should they anger her, may find it hard to objectively evaluate a transaction involving such a shareholder and stand up to the controlling shareholder. The courts do not trust the decisions of directors under these circumstances, and hence reserve to themselves the power to review the transaction more closely.

But is the strong deference to board approval in the absence of a controlling shareholder justified? That is our question. We are concerned that directors are unlikely to be as objective in judging transactions involving their fellow directors (or high-level officers) as the current deferential approach suggests. Before moving to that question, we note one situation *not* involving controlling shareholders where Delaware courts show more skepticism, and hence apply greater scrutiny. That is the case where a corporation establishes a special litigation committee ("SLC") after demand

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[136]*See* Vladimir Atanasov, Bernard S. Black & Conrad S. Ciccotello, *Self-Dealing by Corporate Insiders: Legal Constraints and Loopholes*, *in* RESEARCH HANDBOOK ON THE ECONOMICS OF CORPORATE LAW (Claire A. Hill & Brett H. McDonnell ed.) (manuscript at 6) (forthcoming 2012), *available at* http://ssrn.com/abstract=1714591.

[137]*Id.*

[138]*See generally* Velasco, *supra* note 20, at 824-25.

[139]DEL. CODE ANN. tit. 8, § 141(k) (West 2001) (providing that unless one of the enumerated exceptions applies, "[a]ny director or the entire board of directors may be removed, with or without cause, by the holders of a majority of the shares then entitled to vote at an election of directors").

has been excused (or probably would be), to review a complaint and recommend whether or not a case should be dismissed.[140] Where such a committee recommends dismissal, Delaware courts require the committee to establish that it was independent and exercised good faith and reasonable diligence in investigation.[141] If the committee meets that standard, the court may (at its discretion) apply its independent judgment to whether dismissal is in the best interests of the corporation.[142]

At least in some cases reviewing SLC recommendations, Delaware courts have looked carefully at the independence of the SLC members.[143] Even though they apply the same abstract standard for independence, they seem to apply that standard more strictly.[144] The leading instance of such scrutiny is *Oracle*.[145] Close social and professional ties among the defendant directors and the SLC members, especially ties involving the defendants as contributors to Stanford University where the SLC members taught, were enough to call independence into question.[146] This case seems to reflect a different attitude than *Beam*. That, in part, is due to the different allocation of the burden of proof in the two contexts.

Thus, another way to think of our question is as follows: are the chances of director bias sufficiently greater in the SLC context to justify much closer scrutiny than in the context of approving interested transactions (other than controlling shareholder freezeouts)? It seems intuitively plausible that disinterested directors may be more reluctant to conclude that their fellow directors should be sued than to conclude that their fellow directors have negotiated a sweetheart deal with the corporation which should not be approved. So, somewhat greater scrutiny may be appropriate in the former context. But are the contexts *really* that different? Both involve standing up to a colleague and saying that the colleague has done the company wrong and should be stopped. There is good reason, in both cases, to question how willing most human beings will be to take such a socially,

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[140] *See* Zapata Corp. v. Maldonado, 430 A.2d 779 (Del. 1981).

[141] *Id.* at 788 ("First, the Court should inquire into the independence and good faith of the committee and the bases supporting its conclusions. . . .").

[142] *Id.* at 789 ("If, however, the Court is satisfied . . . that the committee was independent and showed reasonable bases for good faith findings and recommendations, the Court may proceed, in its discretion, to the next step. . . . [The second step allows the] Court [to] determine, applying its own independent business judgment, whether the motion should be granted."). At least one state applies the *Zapata* standard to all demands upon the board. *See* Alford v. Shaw, 358 S.E.2d 323, 326 (N.C. 1987).

[143] *See In re* Oracle Corp. Deriv. Litig., 824 A.2d 917 (Del. Ch. 2003).

[144] *See id.* at 947.

[145] *Id.* at 920.

[146] *Id.* at 929-39.

personally, and professionally awkward position. Of course, recognizing the similarity in the two instances does not automatically lead one to conclude that higher scrutiny should apply to approval of interested transactions; one could instead argue that lower scrutiny should apply to SLC recommendations.[147] We think, though, that there is reason for close judicial scrutiny of how actively independent directors have been in all of these cases. We turn to some reasons for thinking so in the next Part.

IV. OUR APPROACH

Delaware law requires that transactions and decisions involving interested directors need to be cleansed. Its typical solution in the corporate governance area, and its solution in this context, relies heavily on process. If the right process is followed, the board's decision or action is accorded considerable deference. We agree with the law's approach conceptually. Our disagreement is as to what constitutes the right process. We agree that disinterested and independent directors could cleanse a transaction or decision involving interested directors. But we think that independence is too easily presumed or accepted in Delaware law. The broader problem is structural bias: Nominally disinterested and independent directors are nevertheless inclined—because of a desire to retain their board seats, because they share a mindset and common interests with other executives, and/or because of their ties with these particular directors—not to exercise independent and critical judgment as to matters involving their peers.[148] In

[147]For instance, Steve Bainbridge takes that position. BAINBRIDGE, *supra* note 1, at 402 ("Delaware courts would do well to adopt a simpler standard, which asks whether the board of directors is so clearly disabled by conflicted interests that its judgment cannot be trusted. If so, the shareholder should be allowed to sue. If not, the shareholder should not.") (citations omitted). Kenneth Davis makes an argument for a different kind of scrutiny. He argues that SLC determinations should be scrutinized for substance rather than for independence of the committee members. *See* Kenneth B. Davis, Jr., *Structural Bias, Special Litigation Committees, and the Vagaries of Director Independence*, 90 IOWA L. REV. 1305, 1307 (2005).

[148]*See generally* Nicola Faith Sharpe, *The Cosmetic Independence of Corporate Boards*, 34 SEATTLE U. L. REV. 1435, 1449 (2011) ("[S]tructural bias and groupthink may constrain [a] director's independent judgment. . . . [B]oard members form close relationships that make it unlikely that a director will voice an opinion that runs contrary to the position taken by the majority of other board members. Directors value their close relationships and will work to maintain them even at the expense of optimal decision-making.") (citations omitted); Velasco, *supra* note 20, at 860-65; Hill & McDonnell, *Structural Bias*, *supra* note 27, at 853 ("[M]ost boards are comprised of people selected by management . . . . [M]ost directors are from the same social group as officers . . . . As members of the same social group, directors might naturally see issues from an officer's perspective . . . . For all these reasons, the board's critical faculties may not be fully engaged because the directors are biased against corporate interests and in favor of the not-infrequently-differing interests of officers, controlling stockholders, fellow directors, or themselves. The specter

the contexts where a searching inquiry is done—freezeouts and special litigation committees—these types of factors are considered. Directors have the burden to show independence, a burden they sometimes fail to meet.[149] We think a searching inquiry in other contexts would yield similar results. Why is such an inquiry not made? Because the inquiry is costly, and because taking structural bias more seriously runs afoul of a more general credo of deference[150] arising from a broad presumption of independence. The law seems to be saying: 'Where we are especially wary that directors may not be acting objectively, we will do a searching inquiry. In other cases, we will trust to general presumptions.' Our thesis is that there are more circumstances than the law presently contemplates where the general presumptions should not be so strongly held. The presumption should be more easily rebutted and the burden regarding independence should more readily be shifted.

In this regard, consider the discussion in one of the early *Disney* decisions[151] about the independence of director Revata Bowers, the principal of the elementary school Disney CEO Michael Eisner's children had attended.[152] The plaintiffs argued that "because Bowers' salary as a teacher is low compared to her director's fees and stock options, only the most rigidly formalistic or myopic analysis would view Bowers as not beholden to Eisner."[153] The court disagreed.[154] We do not; we think plaintiffs are

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of structural bias looms large."). For an argument that emphasizing structural bias in criticisms of board decision-making is misplaced, see Davis, *supra* note 147, at 1308-09.

[149] *See, e.g.*, London v. Tyrell, 2010 WL 877528, at *16 (Del. Ch. Mar. 11, 2010), *reprinted in* 36 DEL. J. CORP. L. 359, 382-83 (2011) ("SLC members should be selected with the utmost care to ensure that they can, in both fact and appearance, carry out the extraordinary responsibility placed on them to determine the merits of the suit and the best interests of the corporation, acting as proxy for a disabled board. In this case, I am not satisfied that the independence prong of the *Zapata* standard has been met."); Kahn v. Tremont Corp., 694 A.2d 422, 430 (Del. 1997) ("The record is replete with examples of how the lack of the Special Committee's independence fostered an atmosphere in which the directors were permitted to default on their obligation to remain fully informed.... [W]e [thus] conclude that the Special Committee did not operate in a manner which entitled the defendants to shift from themselves the burden which encumbers a controlled transaction.").

[150] Consider in this regard the *Blasius* line of cases, Blasius Indus. v. Atlas Corp., 564 A.2d 651 (Del. Ch. 1988), discussing the rationale for requiring defendant directors to show a "compelling justification" for interfering with the shareholder franchise. The court noted that "[t]he shareholder franchise is the ideological underpinning upon which the legitimacy of director power rests." *Id.* at 659. Boards get considerable deference (when they act, and when they do not); to justify such deference, we look carefully at the integrity of the process by which directors are chosen. We also ensure (or more precisely, purport to ensure) that the directors warrant deference insofar as they are not compromised by interest or lack of independence.

[151] *See In re* Walt Disney Co. Deriv. Litig., 731 A.2d 342, 353-54 (Del. Ch. 1998), *aff'd in part, rev'd in part sub nom.* Brehm v. Eisner, 746 A.2d 244 (Del. 2000).

[152] *Id.* at 359-60.

[153] *Id.* at 359 (internal quotations and footnotes omitted).

correct.[155] But, again, our disagreement with Delaware's approach is more one of degree than of kind. We think Delaware understands in principle what independence means, but sometimes does not search for it enough. An important articulation of what independence means is in *Oracle*: "[T]he question of independence 'turns on whether a director is, *for any substantial reason*, incapable of making a decision with only the best interests of the corporation in mind.' . . . [The cases] ultimately 'focus on impartiality and objectivity.'"[156] The quote continues:

> Delaware law should not be based on a reductionist view of human nature that simplifies human motivations on the lines of the least sophisticated notions of the law and economics movement. *Homo sapiens* is not merely *homo economicus*. We may be thankful that an array of other motivations exist that influence human behavior; not all are any better than greed or avarice, think of envy, to name just one. But also think of motives like love, friendship, and collegiality, think of those among us who direct their behavior as best they can on a guiding creed or set of moral values.

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[154]*Id.* at 360 (stating that adopting the plaintiffs' analysis would "discourage the membership on corporate boards of people of less-than extraordinary means. Such 'regular folks' would face allegations of being dominated by other board members, merely because of the relatively substantial compensation provided by the board membership compared to their outside salaries.").

[155]In *Disney*, insofar as demand was sought to be excused under the interest and independence prong of *Aronson*, the result would not have changed regarding Disney's hiring of Michael Ovitz as President at his then-friend Eisner's behest. Even if Bowers wasn't independent of Eisner, Eisner himself was appropriately found not to be interested. But the result would change regarding Ovitz's firing. Note, though, that this type of example concerns Bowers' domination by Eisner. We agree with then-Vice Chancellor Strine in *Oracle* that the two choices for a compromised director are not just "interest" and "dominated or controlled by someone with an interest." *See In re* Oracle Corp. Deriv. Litig., 824 A.2d 917, 938-40 (Del. Ch. 2003).

[156]*Oracle*, 824 A.2d at 920 (quoting Parfi Holding AB v. Mirror Image Internet, Inc., 794 A.2d 1211, 1232 (Del. Ch. 2001)). We think that the question "what is independence?" is a different question than "how do we determine whether someone is independent?" That being said, federal securities laws and rules, and stock exchange rules have formal definitions of "independence"; directors meeting those definitions are "independent." The definition is a proxy, adopted for its ease of use. We think, as do many other commentators, that the proxy is flawed, and its use has many associated costs. *See, e.g.*, Fairfax, *supra* note 54, at 146-47; Mohsen Manesh, *Indeterminacy and Self-Enforcement: A Defense of Delaware's Approach to Director Independence in Derivative Litigation*, 6 J. BUS. & SEC. L. 177, 196 (2006); Usha Rodrigues, *The Fetishization of Independence*, 33 J. CORP. LAW 447, 464-66 (2008). *See generally* Bainbridge, *supra* note 75, at 1081-83 (discussing the realities and factors that skew independence and ALI's approach to fixing it). In our view, the Delaware definition more cleanly and directly defines independence. But we do not want to argue here that the federal and stock exchange definitions are pernicious or even useless; they may serve useful purposes, a subject largely beyond the scope of this Article.

> Nor should our law ignore the social nature of humans. To be direct, corporate directors are generally the sort of people deeply enmeshed in social institutions. Such institutions have norms, expectations that, explicitly and implicitly, influence and channel the behavior of those who participate in their operation. Some things are "just not done," or only at a cost, which might not be so severe as a loss of position, but may involve a loss of standing in the institution. In being appropriately sensitive to this factor, our law also cannot assume—absent some proof of the point—that corporate directors are, as a general matter, persons of unusual social bravery, who operate heedless to the inhibitions that social norms generate for ordinary folk.[157]

Critically for our argument, there is nothing about this statement that limits its applicability to the two contexts in which Delaware does the kind of inquiry the court did in *Oracle*, the special litigation context at issue in *Oracle* and the controlling shareholder freezeout context.[158] Quite the contrary—it speaks generally, about human nature.[159] Whenever a director is interested as to the initial transaction or decision, other directors might, for reasons so well explained here, even though disinterested and "independent" by all formal measures, nevertheless lack objectivity and impartiality.[160] Opinions such as *Beam* and the early *Disney* case, in which the plaintiff's burden to show lack of independence seems almost impossible to meet except with a showing of canonical familial or financial connections, are at odds with the court's recognition in *Oracle* and *Zapata* as to directors' "human nature."[161] Certainly, voluminous social science literature attests to

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[157] *Oracle*, 824 A.2d at 938 (citations omitted).

[158] *See supra* notes 132-47 and accompanying text.

[159] *Oracle*, 824 A.2d at 938 ("Nor should the law ignore the social nature of humans.").

[160] Our argument here is very much in the spirit of the argument made in Antony Page, *Unconscious Bias and the Limits of Director Independence*, 2009 U. ILL. L. REV. 237 (2009) (arguing that directors are subject to unconscious biases that may influence their decision-making in ways that might cause them to be less critical of their peers).

[161] *Compare* Beam *ex rel* Martha Stewart Living Omnimedia, Inc. v. Stewart, 845 A.2d 1040, 1049 (Del. 2004) ("A director will be considered unable to act objectively with respect to a presuit demand if he or she is interested in the outcome of the litigation or is otherwise not independent. A director's interest may be *shown by demonstrating a potential personal benefit or detriment* to the director as a result of the decision.") (emphasis added) (citation omitted), *with Oracle*, 824 A.2d at 938 as quoted in the text accompanying note 157 ("Delaware law should not be based on a reductionist view of human nature that simplifies human motivations on the lines of the least sophisticated notions of the law and economics movement. . . . [M]otives like love, friendship, and collegiality, think of those among us who direct their behavior as best they can on a guiding

the fact that anyone's decision making can be affected, consciously and unconsciously, by factors such as in-group bias (which includes simply seeing the world the way one's in-group does) and motivated reasoning (reasoning that manages to yield the decision-maker's desired conclusion).[162]

It is worth taking a step back and asking what we want to achieve with director independence. What are our aims? Is it a matter of process, of results, or both? That is, do we want independence because directors 'ought' to be independent, or because we think independent directors will do a better job? "Both" might seem, at first blush, to be the obvious answer, but on further reflection, the matter becomes murkier. We probably think, as an abstract matter, that directors shouldn't be cronies; we probably also think, although with less force, that non-cronies will do a better job. But efforts to demonstrate that more independent boards lead to better performance have not been successful. The empirical evidence is decidedly mixed.[163] Admittedly, the measure of independence used has not been Delaware's measure—it has been the measure used by federal securities law and stock exchanges, involving canonical relationships such as close familial ties, employment, and other money relationships.[164] But using these types of

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creed or set of moral values.").

[162]Page, *supra* note 160, at 249-50, 262-64; *see also* Claire A. Hill, *Why Did Anyone Listen to the Rating Agencies After Enron?*, 4 J. BUS. & TECH. L. 283, 288 (2009) (describing how motivated reasoning may make overcoming pre-existing beliefs more difficult).

[163]*See, e.g.*, Sanjai Bhagat & Bernard Black, *The Non-Correlation Between Board Independence and Long-Term Firm Performance*, 27 J. CORP. L. 231, 231 (2002) ("We conduct the first large-sample, long-horizon study of whether the degree of board independence . . . correlates with various measures of the long-term performance of large American firms. We find evidence that low-profitability firms increase the independence of their boards of directors. But there is no evidence that this strategy works. Firms with more independent boards do not perform better than other firms."); Fairfax, *supra* note 54, at 174-75 ("The empirical evidence on the benefits associated with director independence is mixed at best."); Rodrigues, *supra* note 156, at 461. Recall, too, the enormous success of Disney under Michael Eisner when the board was generally considered to be a "rubber stamp" board. *See* John A. Byrne, Ronald Grover & Richard A. Melcher, *The Best and Worst Boards*, BUS. WK., Dec. 8, 1997, at 90, *available at* http://www.businessweek.com/1997/49/b3556001.htm. Note, though, that this "rubber stamp" board was deemed independent under Delaware law for purposes of determining whether demand would be excused. *In re* Walt Disney Co. Deriv. Litig., 731 A.2d 342, 361 (Del. Ch. 1998), *aff'd in part, rev'd in part sub nom.* Brehm v. Eisner, 746 A.2d 244 (Del. 2000). We suspect it might not have been, or at least the case would have been closer, had the *Oracle/Weinberger* scrutiny and burden shift applied. *In re* Oracle Corp. Deriv. Litig., 824 A.2d 917, 941-42 (Del. Ch. 2003). Might it be possible that performance could suffer if a board were more independent? This possibility has been raised. Larry Mitchell, for instance, argues that where a board is mostly independent, the inside director might be accorded deference regarding information about the corporation. The independent directors might not do their own inquiry, and might be willing to accept incomplete or self-serving disclosures. *See* Lawrence Mitchell, *Structural Holes, CEOs and Information Monopolies: The Missing Link in Corporate Governance*, 70 BROOK. L. REV. 1313, 1348-50 (2005).

[164]*See, e.g.*, Sarbanes-Oxley Act of 2002 § 301, 15 U.S.C. § 78j-1 (2006); N.Y. STOCK

definitions is at least tractable. Under the federal approach, a director is either independent or she is not, for all purposes.[165] By contrast, measuring the independence of a board using the Delaware test would be much more difficult. The inquiry is not at all mechanical. Furthermore, to overstate matters, it may be conceptually incoherent. Insofar as independence is independence in a particular context, how would we assess how independent a board was generally, for purposes of determining how independence affected the corporation's performance? Independence is considered in relation to a particular transaction;[166] a director could be independent for one purpose and not for another.[167] That being said, we do not want to overstate this point. The value of independence in particular contexts, such as the size of a takeover premium, can certainly be measured.[168] Still, the bottom line conclusion may be that the most defensible posture is to value and pursue independence for process-related reasons. We want courts to focus on making sure the appropriate process is followed. We do not want courts to micromanage the substance of business decisions; in any event, it is not clear how an assessment of the substance would or should be made. Conceiving of the aim as 'the decisions produced by the appropriate process' seems more tractable and unambiguously sensible than 'better decisions.'[169] Thus, the independence at issue ought to be one that focuses more directly on addressing reasons why process might be defective in particular cases.[170]

We propose one simple change and one clarification to Delaware law. The simple change is to review other situations involving an interested director along lines closer to current review of transactions with controlling shareholders and an SLC's decision to terminate (or not bring) a lawsuit. If any director has a conflicting interest in a transaction, in order to cleanse the taint of interest and receive the benefits of business judgment deference, defendants would first have to show that the disinterested directors approving the transaction exercised independent business judgment.

The clarification applies to transactions involving an interested controlling shareholder outside of the freezeout context. Courts should

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EXCH., INC., LISTED CO. MANUAL § 303A (2011), *available at* http://nysemanual.nyse.com.

[165] *See* Page, *supra* note 160, at 242-43.

[166] Fairfax, *supra* note 54, at 134-35.

[167] *See id.*

[168] *See* Cain & Davidoff, *supra* note 84, at 890. But there are other contexts where independence is important, such as special litigation committees, where measurement would seem to be more difficult.

[169] An author making a related point is Davis, *supra* note 147, at 1309.

[170] That being said, we do not want to argue here that there is no role for the federal approach. Given the complexity, expense, and indeterminacy of a Delaware-style determination, the more mechanical federal approach may have its place in particular contexts, a subject beyond the scope of this Article.

clarify that the *Weinberger* framework applies to all transactions with controlling shareholders, although the procedure required to shift the burden as to fairness depends on the nature of the transaction. Courts will naturally require boards to show a more rigorous procedure in cases involving the selling of the corporation than for more minor interested transactions. Note that under our approach, courts would still treat cases involving controlling shareholders with less deference than other interested transactions. In both cases, defendants would need to show that the disinterested directors exercised independent business judgment. But at least two differences would remain. First, the burden of showing independence will typically be harder in cases involving controlling shareholders—the fact of control itself militates against a finding of independence, so the procedure required to convince a court of independence must be correspondingly more rigorous. Second, where defendants do succeed in demonstrating independent director approval, in cases involving controlling shareholders the standard of review remains entire fairness, albeit with a burden shift, whereas in non-controlling shareholder cases the standard of review is business judgment.

Many, and probably most, cases involving an interested director transaction would be derivative suits where the harm was to the corporation, and a shareholder had to meet the *Aronson* test in order to proceed. Thus, we would also want to make changes to the first prong of *Aronson*. Under that prong, demand is excused if plaintiff can plead particularized facts that raise a reasonable doubt that the directors are disinterested and independent. We would want the rule to be that if the plaintiff can show that at least one director is interested, demand will be excused unless defendants can meet the burden of showing that the approving majority of disinterested directors exercised independent business judgment and the plaintiff cannot rebut this showing with evidence of particularized facts casting doubt on the directors' exercise of independent business judgment. Such evidence would be assessed on a case-by-case basis, but might include evidence of close personal or financial ties, or perhaps a form of "waste-lite"—a showing that the transaction or decision is markedly unfavorable to the corporation as compared with an appropriate comparison group. Note the contrast between this formulation and present law. Not only is the burden shift different, the nature of the inquiry is different as well. Notably, a director could lack independence notwithstanding not being "dominated or controlled" by the interested director. In the early *Disney* case, by contrast, not only did the burden not shift, the inquiry was confined to whether a director was interested, or dominated or controlled by an interested director.[171] We agree with then-Vice Chancellor (now Chancellor) Strine in *Oracle* when he said that a director is not independent merely because he is neither interested nor dominated by someone who is.[172]

Finally, if the transaction at issue involved a controlling shareholder (as defined in the *Weinberger* line of cases), that would suffice to excuse demand. This last change brings *Aronson* in line with the *Weinberger* approach to director independence in the presence of controlling shareholders. Defendants would still be able to point to disinterested director approval as cleansing the transaction, but with a controlling shareholder they would have to do so after the pleading process addressed in the *Aronson* demand excusal framework. This again contrasts with our proposed treatment of the non-controlling shareholder context, where we would give defendants the chance to demonstrate independent approval at the *Aronson* stage.

We are mindful that our approach would be costly, and might give plaintiffs more ability to bring meritless suits to exact settlements, distracting managements from running companies and perhaps discouraging good candidates from being willing to be directors. We are mindful, too, that there is no mechanical way for a company to bullet-proof itself against an *Oracle*-type inquiry. But we think this last attribute may yield a benefit: Companies might internally conduct precisely the inquiry they would expect that a court might conduct, and might err on the side of caution in their selection of directors and in their "cleansing" procedures.[173] There is ample anecdotal evidence that "independent" committees have sometimes been anything but—that they have been hired because they had the nominal characteristics of independence but knew that their charge was to do as the interested directors wished.[174] After all, one very rarely hears about an

[171] *See In re* Walt Disney Co. Deriv. Litig., 731 A.2d 342, 359-60 (Del. Ch. 1998), *aff'd in part, rev'd in part sub nom.* Brehm v. Eisner, 746 A.2d 244 (Del. 2000).

[172] Strine also made a similar point in his 2002 article on Enron:

> Why should the law *presume* that an outside director can impartially decide to sue his long-standing personal friend, the CEO? Why should the law *presume* that rational, outside directors enter into economic contracts with the corporation—such as consulting arrangements—that are immaterial to themselves? Why should the law *presume* that a director who is also the head of a charity receiving charitable contributions directed largely by corporate management, will not fear that such contributions would be reduced if he acts contrary to management's wishes?

Strine, *supra* note 52, at 1382.

[173] *See* Manesh, *supra* note 156, at 178 (making basically this same argument, couching the mechanism as "self-enforcement.").

[174] One of us has had extensive conversations with various practitioners, all of whom have

independent committee deciding that suing a company's interested directors is a good idea. But these benefits might be counterbalanced by costs: People who might conceivably have their independence questioned but who would provide real value to the corporation might not to be selected as directors. Still, we think on balance the cost is worthwhile given the gravity and pervasiveness of the problem.

Our approach is not at all radical. Indeed, it is weaker than pre-statutory common law. It also fits well with Delaware law's continuing emphasis on the role of procedure; it also accords with the emphasis in Delaware and at the federal level on the importance of independent directors.

V. APPLICATIONS OF OUR APPROACH

In this Part, we discuss several applications of our approach: management buy-outs, responses to takeovers more broadly, executive compensation, and decisions involving controlling shareholders other than freezeouts.

Management buy-outs are clearly interested director transactions. The present standard of review is murky. Certainly, given that they are interested transactions, they must be approved by informed disinterested directors.[175] Moreover, *Revlon* may also apply.[176] Our approach would dictate scrutiny of the independence of the approving directors, as per *Weinberger*, and also active involvement in bargaining and getting the best deal for the corporation; the formation of a special committee which uses independent advisors should be encouraged.[177] More specifically, defendants would have the burden to show that approving disinterested directors acted independently. This would involve considering both their ties to interested directors and the process they used in approving the transaction. If the defendants can show they proceeded in this manner, they should be entitled to business judgment deference, with plaintiffs required to show waste or lack of good faith to prevail. If not, defendant directors should have the burden to show that the transaction is fair to the corporation.[178]

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said some variant of this.

[175]The law is unclear as to whether the approving directors must be independent; it seems, perhaps, if plaintiffs can show they were not independent, that may defeat the cleansing effect.

[176]*See* Bainbridge, *supra* note 88, at 803.

[177]Cain & Davidoff, *supra* note 84, at 890-91.

[178]Most MBO cases would probably be brought as direct actions. Should such a case be brought as a derivative action, under our proposed framework demand would be excused (since at least some directors in an MBO have an explicit conflict of interest) unless defendants could show in the pleadings that the approving majority of disinterested directors exercised independent business judgment and the plaintiff cannot rebut this showing—raising the same basic questions at the pleading stage as the issues discussed in the text.

Responses to takeovers generally also may raise issues. Still, we must be mindful not to go too far: we think the general presumptions of independence, and general credo of deference, are appropriate except in limited circumstances. Where boards are responding to takeovers, the obvious concerns are that they may favor an acquirer who is giving them a particular benefit, such as keeping them on at advantageous terms (or, as in *Revlon*, limiting their exposure to lawsuits brought by ex-shareholders who had become creditors in an exchange offer) or disfavor an acquirer who would not keep them on. In these types of cases, if plaintiffs could show that at least one member of the board had a material conflicting interest in the transaction, as traditionally understood, the defendants would then bear the burden of showing that the approving majority of disinterested directors exercised independent judgment.[179]

Executive compensation of an officer who is also a director is an important context in which our approach should apply. We are quite sympathetic to the arguments that executive compensation is particularly subject to structural bias;[180] hence, we would want courts to be especially mindful of the possibility. A paradigmatic way for the issue to present itself is with a rubber-stamp board, as Disney was considered to be at the time Ovitz was hired.[181] The court should more closely scrutinize whether directors are in fact exercising fully informed independent business judgment.

If plaintiffs are able to allege that a director is interested, demand should be excused unless the defendants can bear the burden of showing that the board exercised independent business judgment, and the plaintiff does not successfully rebut that showing. More specifically, once plaintiffs allege that a director is interested, defendants can rebut with evidence that directors were fully informed and independent and used adequate process (including, of course, compliance with applicable federal and stock exchange rules on composition and conduct of compensation committee). Plaintiffs could then rebut by showing additional persuasive evidence that the decision was not made using independent business judgment; such evidence might include close personal or financial ties, or perhaps a showing that the compensation at issue was dramatically unfavorable to the corporation as compared with an appropriate comparison group, or was far less responsive to performance than presented by the defendants. Plaintiffs could use Section 220 of the

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[179] As usual, if the case is classified as derivative in nature, the same basic question will arise first on the pleadings in analyzing whether demand is excused.

[180] *See generally* BEBCHUK AND FRIED, *supra* note 98

[181] *See* Byrne et al., *supra* note 163.

DGCL[182] to acquire information to make their case, but they would not be entitled to discovery. If the defendants could meet their burden and the plaintiffs could not successfully rebut, the case would be dismissed. If the case is not dismissed on the pleadings, it would proceed. Here again, defendants would have the burden of showing the approving majority of directors exercised their independent judgment. If the defendants succeeded, business judgment deference would apply.[183]

Ultimately, the case outcomes might not differ, but corporations might be incentivized to pick directors whose independence could more easily be established.[184] They might also be more inclined to seek informed shareholder approval. In addition to other benefits of seeking such approval, they might be constrained to only propose compensation packages they can easily defend. That being said, we are considering whether the recent requirement that public companies have non-binding "say on pay" votes at their annual meetings[185] effectively would render this analysis moot insofar as the 'interested transaction' was being cleansed via shareholder approval. At first blush, it might seem that "say on pay" should suffice as shareholder approval, but we think the matter is more complex. One reason is that the vote is non-binding;[186] the other is a sense that we share with at least one commentator that the votes have somehow seem ritualized and hollow, not really about the substance of the decision.[187] As the commentator notes: "The latest 'say on pay' endeavor has turned into a costly exercise that

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[182]DEL. CODE ANN. tit. 8, § 220 (West 2001).

[183]Note that for derivative actions, the same logical structure gets repeated first as to the pleadings and then after the parties are able to engage in discovery. Many find this structure unsatisfying. We do not question it for purposes of this Article; we merely fit our suggestions within the existing structure of Delaware law for derivative actions.

[184]This mechanism would be similar to that described in Manesh, *supra* note 156.

[185]This requirement was imposed by the SEC pursuant to Dodd-Frank § 951. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 951, 124 Stat. 1376, 1899-1900 (2010) (codified at 15 U.S.C. § 78n). The SEC final rule is Rule 14a-21(a) under the Securities Exchange Act of 1934, 17 C.F.R. § 240.14a-21(a) (2011).

[186]15 U.S.C. § 78n-1.

[187]While analytically we can see the argument that such votes ought to cleanse interested executive compensation determinations, we are concerned that the exceedingly high percentage of "yes" votes, together with the recommendations by the highly influential proxy advisory services to vote "no" when shareholders are displeased with other aspects of a corporation's behavior, suggests that shareholders' votes approving pay should not cleanse in the way that, for instance, their votes for a merger should cleanse. For an interesting discussion of the potentially perverse effects of "say on pay," see Steven M. Davidoff, *Efforts to Rein in Executive Pay Meet with Little Success*, N.Y. TIMES, July 12, 2011, at B7, *available at* http://dealbook.nytimes.com/2011/07/12/efforts-to-rein-in-executive-pay-meet-with-little-success/. We do not know how the fact that the votes are non-binding fits into this analysis; presumably, it supports the idea that the votes should not cleanse the determinations.

validates almost every companies' pay practices. . . . [There has been a] 98.5 percent approval rate. I'm sorry, but I'm a bit cynical that 98.5 percent of any group is doing the right thing."[188] Certainly, corporations are crafting their compensation packages mindful of the fact that shareholders now have a "say." But the packages are not materially different from those in the pre-say days. Maybe the packages were mostly acceptable before say on pay was required, and the changes companies have made were sufficient to produce meaningful well-informed approval. But there are many reasons to doubt this optimistic perspective.

For cases involving controlling shareholders but not involving freezeouts, under our approach demand would simply be excused. At that point, plaintiffs could bring the suit. But if defendants could show that the transaction was approved by disinterested directors who were independent and followed appropriate procedure,[189] the plaintiffs would bear the burden of showing the transaction was not fair to the corporation. If defendants could not make this showing, they would bear the burden of showing the transaction was fair to the corporation. We think ultimately that *Stewart v. Beam* would have come out the same way. But rather than simply saying that demand was not excused, the court should have excused demand and instead made a *Weinberger*-type inquiry.

VI. CONCLUSION

Transactions and decisions involving interested directors are an important concern for corporate governance. A corporation's legitimate interest holders are entitled to have the corporation run in their interest; there ought to be ways to ensure that the agents running the corporation are acting for their principals. Corporate law's acceptance and recognition of this principle collides with other countervailing forces—avoiding micromanagement of business and thus affording significant deference to those charged with the business's management. Much of corporate law attempts to deal with this well-known problem, but the problem persists. We suggest here that an approach already developed for dealing with the problem in two particular contexts can profitably be applied more broadly. The approach is not monolithic: it is not to be applied identically in all cases. In particular, some types of cases might warrant far more extensive scrutiny

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[188] *Id.*

[189] The procedure required to make this showing will vary depending upon the importance of the underlying decision. Boards need not do nearly as much to scrutinize a modest grant of stock to a controlling shareholder as to scrutinize a freezeout.

than others. In some cases, the burden should shift more readily than in others, and be satisfied far more readily than in others. In some cases, in particular in cases other than those involving a controlling shareholder, once independent director approval was shown, the board's decision would get business judgment deference. But the essential features—the burden shift, and sensitivity in determinations of independence to the possibility of structural bias—should always be applicable.

Adopting our approach would have benefits beyond those of dealing more effectively with interested director transactions. It would give corporate law more coherence, with independence treated more consistently. It might even encourage courts and the broader corporate governance community to approach the broader problem of structural bias in a more principled, less mechanical, and less deferential manner.