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VAN GORKOM'S LEGACY: THE LIMITS OF JUDICIALLY ENFORCED CONSTRAINTS AND THE PROMISE OF PROPRIETARY INCENTIVES

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Smith v. Van Gorkom[1] is at the center of the most remarkable period of judicial activity in corporate law in the twentieth century. Its appearance in January 1985 came eleven months after *Aronson v. Lewis*[2] and twenty-three months after *Weinberger v. UOP, Inc.*,[3] *Unocal, Inc. v. Mesa Petroleum Co.*,[4] and *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*[5] appeared before the end of 1985.[6] Along with these other landmark decisions commonly found in most corporations casebooks, *Van Gorkom* illustrates the twin pillars of Delaware corporate law—the primacy of the board of directors in the law's approach to corporate governance, and the centrality of common-law courts (and their interpretations of fiduciary duty) in setting the limits on director power in corporations.

For this handful of decisions the second point is particularly noticeable. Three of the cases—*Van Gorkom*, *Unocal*, and *Revlon*—expand the level of judicial review of director actions, and *Weinberger*, while ostensibly making appraisal the plaintiff's primary remedy in a cash-out merger, provides the "fair dealing/fair price" structure that has become the standard legal test for extensive judicial review in a variety of merger settings. Even *Aronson*, which produced the standard most likely to short circuit litigation, contains

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[1] 488 A.2d 858 (Del. 1985).

[2] 473 A.2d 805 (Del. 1984) (setting out conditions when shareholders filing derivative suit must make demand on directors).

[3] 457 A.2d 701 (Del. 1983) (setting out appraisal as the basic remedy in cash-out mergers and the "fair dealing" and "fair price" aspects that make up a director's fiduciary duty in that context).

[4] 493 A.2d 946 (Del. 1985) (describing enhanced judicial review of defensive tactics via a two-part test of threat and proportional response as a threshold for obtaining business judgment review to a challenge of takeover defenses).

[5] 506 A.2d 173 (Del. 1986) (describing alteration of board's responsibilities and its duty to get the best price for shareholders when break up became inevitable). The opinion was published in 1986 but appeared before the end of 1985.

[6] Other notable opinions also came out during 1985. *See, e.g.*, Moran v. Household Int'l, Inc., 500 A.2d 1346 (Del. 1985); Rosenblatt v. Getty Oil Co., 493 A.2d 929 (Del. 1985). See also the history of the court's decisions in Chief Justice Veasey's remarks in this Symposium (on file with the authors).

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a second prong that permits open-ended judicial review of the substantive nature of a challenged transaction. The preference for judicial review over alternative constraints on directors, including ex ante state or federal legislation, shareholder self-help, markets, private ordering or norms, is most pronounced in *Van Gorkom.* There the Delaware Supreme Court subjected directors to personal liability even though there were no "allegations of fraud, bad-faith or self-dealing or proof thereof."[7]

Viewed with the benefit of hindsight, *Van Gorkom* stands as the apogee in the reach of judicial corporate governance via fiduciary duty, parallel to *Superintendent of Insurance v. Bankers Life & Casualty Co.*[8] as the apogee in the reach of Rule 10b-5 under federal law securities regulation as a means to address corporate governance.[9] The impact of *Van Gorkom* lies not in its holding, which has been eviscerated by subsequent legislative action, but in its refocusing the corporate governance debate on deficiencies in the role of directors and unleashing a richer array of alternative constraints that include markets, contracts, and norms.

This Article has three parts. The first places fiduciary duty in the context of the array of possible constraints on director action and *Van Gorkom*'s place in the development of those various constraints. The second Part then addresses the common-law portion of the post-*Van Gorkom* world: how governance behavior has changed to come within *Van Gorkom*'s holding. The third Part addresses alternative regimes that do not depend on common-law judicial determinations. These include, for example, the rising importance of equity-based ownership for directors as an alternative incentive for appropriate director action, and shareholder self-help via voting or selling instead of relying on judges to enforce fiduciary duty.

I. CORPORATE GOVERNANCE AND THE ROLE OF COMMON-LAW JUDGES APPLYING FIDUCIARY DUTY

The corporation provides a form of business that facilitates a firm's adaptability to new economic conditions. The legal structure anticipates both separation of function and specialization among various groups.[10] Within this specialized business form, the fulcrum for almost all legal

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[7] Smith v. Van Gorkom, 488 A.2d 858, 873 (Del. 1985).

[8] 404 U.S. 6, 11-12 (1971) (holding that "Congress made clear that 'disregard of trust relationships by those whom the law should regard as fiduciaries are all part of a single seamless web' along with manipulation, investor's ignorance and the like" (quoting H.R. REP. NO. 73-1383, at 6, *reprinted in* 5 LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND SECURITIES EXCHANGE ACT OF 1934, at 6 (1973))).

[9] The Supreme Court's decisions in *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975), and *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462 (1977), established more narrow limits for Rule 10b-5, a trend in federal law that continues to the present.

[10] The corporate form separates entity functions between directors, shareholders, and officers, in contrast to the partnership where the statutory form anticipates all of those functions to be performed by one group—partners.

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power is the board of directors.[11] Directors' control over "vast aggregations of property that they do not own"[12] not surprisingly triggers discussion of constraints on such power. *Van Gorkom* illustrates the most visible constraint in corporate law—directors have common-law fiduciary duties, primarily of care and loyalty, in the decisions they make on behalf of the collective enterprise. These duties are usually enforced by shareholder-initiated derivative suits or class actions, leading to judicial orders where necessary to rein in improper director action.

The prominence given to the litigation vehicle in law school courses and in the daily life of lawyers specializing in corporate law often overshadows the variety of other constraints on director behavior, including the following:[13]

Markets—Product markets indirectly constrain managers' decisions, as do the capital market, the market for managerial services, and the market for corporate control. A manager's desire to obtain employment in the future or to avoid a hostile takeover of the corporation sometimes can influence decisions more than fiduciary duty.

Contracts and Other Private Ordering—While markets reflect aggregate economic incentives, contracts and similar arrangements permit private ordering tailored to the parties' particular economic-based motivations. These may be structured to provide incentives or to facilitate monitoring, for example by aligning directors with shareholders through the use of equity ownership.

Law—State corporations codes provide an ex ante governance structure identifying rights of directors, shareholders, and others, usually with provisions permitting parties to modify the structure. Federal securities law provides additional ex ante, but less modifiable, structures that often constrain what directors may do, usually by focusing on mandatory disclosure. These rules can be changed from time to time by the appropriate legislative bodies. More frequent legal constraints on directors derive from the ex post gap filling of legislative rules by judges, often through application of fiduciary duty.

Norms—The burgeoning literature on norms identifies governance constraints not mandated or enforced by law but still visible, a trend that is more recognized today than at the time *Van Gorkom* was decided.[14]

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[11] *See* DEL. CODE ANN. tit. 8, § 141(a) (1991) ("The business and affairs of every corporation . . . shall be managed by or under the direction of a board of directors . . . .").

[12] Blasius Indus. Inc. v. Atlas Corp., 564 A.2d 651, 659 (Del. Ch. 1988).

[13] *See generally* Robert B. Thompson, *The Law's Limits on Contracts in a Corporation*, 15 J. CORP. L. 377 (1990).

[14] For a broad discussion of the impacts of norms on corporate law, see Symposium, *Norms & Corporate Law*, 149 U. PA. L. REV. 1607 (2001). *See also* Donald C. Langevoort, *The Human Nature of Corporate Boards: Laws, Norms and Unintended Consequences of Independence and Accountability*, 89 GEO. L.J. 797, 800 (2000) ("I share the sense of many commentators that the law has played a relatively minor role in the evolution of board structure and behavior; markets and other social forces are far more

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While this list provides a context within which the *Van Gorkom* holding might be understood, a complete mapping of this universe must necessarily include the interaction of these various constraints. Shareholder voting rights and mandated disclosure can increase the impact of the market for corporate control. Separation of fiduciary duty into standards of conduct and standards of liability, as evidenced by recent changes to the Model Business Corporation Act, give explicit and broad recognition of the aspirational impact of laws to be enforced by norms, rather than legal consequences.[15]

This universe suggests that a core question to ask about common-law fiduciary duty is this: When does ex post judicial application of these principles have a relative advantage over the other possible constraints listed above? It turns out that the *Van Gorkom* context does not fit within the set of circumstances in which judicial gap-filling is the optimal constraint. For example, private ordering by contract or norms by which directors obtain equity ownership in their companies can be more effective than fiduciary duty in addressing the issues that concerned the court in *Van Gorkom*.

II. *VAN GORKOM*'S EFFECT ON BOARD BEHAVIOR: THE MOVE TOWARD GREATER PROCESS

The *Van Gorkom* decision suggested a more active role for directors in corporate governance and a broader role for judicial review of director decisions than had existed under prior law. Some observers, including some who participated in this Symposium, see *Van Gorkom* as a takeover case,[16] and see in it the beginnings of the Delaware court's attempt to work out the relative roles of directors and shareholders in hostile takeovers that occupied so much of the court's time for the remainder of 1985 and subsequent years.[17] Those connections seem appropriate to us, but we choose to frame our view of *Van Gorkom* by looking in two directions, not only forward toward *Unocal*, *Revlon*, and the subsequent takeover cases, but also back to the prior cases, particularly *Aronson* (which was actually argued after *Van Gorkom*, but published well before it). The two decisions together appear to be a conscious effort by the Delaware court to provide the most developed judicial statement to that point of the business judgment rule and the

important. Indeed I suggest leaving the matter of board independence and accountability largely to these extralegal incentives.").

[15] *See* MODEL BUS. CORP. ACT §§ 8.30-31(1999); *see also* Melvin Aron Eisenberg, *The Divergence of Standards of Conduct and Standards of Review in Corporate Law*, 62 FORDHAM L. REV. 437, 437 (1993) ("A *standard of conduct* states how an actor should conduct a given activity or play a given role. A *standard of review* states the test a court should apply when it reviews an actor's conduct to determine whether to impose liability or grant injunctive relief.").

[16] *See, e.g.*, Jonathan R. Macey & Geoffrey P. Miller, Trans Union *Reconsidered*, 98 YALE L.J. 127 (1988).

[17] *See* Chief Justice Veasey and former Chancellor Allen, Remarks at this Symposium (May 18-19, 2001) (transcript on file with authors).

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role of directors in corporate governance generally.[18] From this vantage point, *Van Gorkom* represents the Delaware court's wake-up call to passive boards that had been the norm in the decades prior to the decision.[19]

Delaware's quick enactment of section 102(b)(7) reversed much of the substantive liability impact of the decision in *Van Gorkom*, so that directors today doing what the Trans Union directors did would not be subject to liability for damages.[20] Most states have followed Delaware in permitting corporations to include a provision in their articles of incorporation or similar document that removes director liability for money damages arising from decisions that breached the directors' fiduciary duty of care absent a claim of disloyalty or bad faith.[21] The result is that almost all large American corporations can choose a legal regime that is less regulatory as to duty of care than *Van Gorkom*, and almost all the corporations that have this option have taken the steps to exercise it. In a study of one hundred of the largest American corporations, Professor Lawrence Hamermesh found that only seven did not have such protection for their directors.[22] Some of those seven were in states that did not permit such exculpation. Less than a handful were corporations incorporated in states that permitted exculpation but had not taken advantage of it.[23] None of this last group was incorporated in Delaware; that is, all fifty-nine Delaware corporations in this sample had exculpation provisions in their corporate charters.[24]

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[18] See Part IV.A of *Aronson v. Lewis*, 473 A.2d 805, 811-17 (Del. 1984), where the court presents a clear statement of the role of directors and the function of the business judgment rule. It is here, as well, where the court for the first time uses "gross negligence" as the applicable standard of care, *id.* at 812, a concept developed in more detail in *Van Gorkom*.

[19] The Delaware court, of course, was not alone in challenging the then current role of directors. The American Law Institute's controversial Corporate Governance Project took its initial shape between the time of the Trans Union transaction in 1980 and the Delaware Supreme Court's published decision in 1985. It emphasized monitoring as the key role of the board of directors. *See* PRINCIPLES OF CORPORATE GOVERNANCE AND STRUCTURE: RESTATEMENT AND RECOMMENDATIONS § 3.02 cmt. c (Tentative Draft No. 1, 1982). The drafters of that document stated their premise succinctly: "Effective duty of care provisions are critical to the proper functioning of modern corporate governance." *Id.* § 4 introductory note, at 128. The *Van Gorkom* opinion reflects this evolving view of the role of directors, but adopts a gross negligence standard for liability in contrast to the ALI draft's "reasonableness, ordinary negligence standard." *Id.* § 4.01 cmt. a, at 143.

[20] DEL. CODE ANN. tit. 8, § 102(b)(7) (1991).

[21] More than 40 states have exculpation provisions. See MODEL BUS. CORP. ACT ANN. § 2.02, Statutory Comparison, note 6, at 2-31.

[22] Lawrence A. Hamermesh, *Why I Do Not Teach* Van Gorkom, 34 GA. L. REV. 477 app. a (1999).

[23] They included Loral Corporation and Xerox Corporation incorporated in New York, PepsiCo incorporated in North Carolina, and State Farm Insurance Companies, a mutual company rather than a stock company, incorporated in Illinois. Of course, those corporations referred to in the previous sentence of the text that incorporated in one of the few states that have not provided exculpation are free to reincorporate in a state that does provide such protection upon a vote of their shareholders, so to that extent those companies choosing not to provide protection for their directors include both of these last groups.

[24] For an earlier study that found that more than 90% of a sample of 180 companies incorporated in Delaware had included an exculpation provision in their charter, see Roberta Romano, *Corporate Gov-*

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The statute's overruling of *Van Gorkom*'s imposition of monetary liability has not made the court's holding a dead letter. Indeed, the case has produced very noticeable changes in board behavior. Two specific alterations that can be traced to *Van Gorkom* are 1) the widespread use of third-party advisers to give expert opinions to the board for various corporate transactions,[25] and 2) the rise of elaborate decision-making procedures involving lengthy meetings, voluminous documentation and the like that today accompany board decisions, as compared to a simpler process in the pre-*Van Gorkom* era.[26]

The full impact of *Van Gorkom* has not been limited just to duty of care cases, for it helped spark a broader focus on the decision-making process in all derivative litigation. Elaborate process-oriented rules have appeared in duty of loyalty settings. In earlier days, judges worked within a simple two-choice decision matrix of either deference, where the business judgment rule applied, or judicial review for fairness, if the presumption was not applicable. Now there is a much more elaborate decision matrix that provides distinct judicial approaches to contexts where, for example, there is an allegation that a demand was wrongfully refused,[27] a board's action after demand was wrongful,[28] or a committee is appointed after demand was legally excused.[29] Likewise, judges have developed a more complex procedural posture for corporate opportunity cases.[30]

Why did directors and their advisers change their behavior to adopt procedures suggested by the opinion when, under legislation enacted shortly after *Van Gorkom*, they do not face personal liability? Exculpation clauses such as section 102(b)(7) relieve only the possibility of personal liability for money damages. Failure to meet the duty of care as set out by the court in *Van Gorkom* can still lead to injunctive action that could stop

ernance in the Aftermath of the Insurance Crisis, 39 EMORY L.J. 1155, 1160-61 (1990).

[25] *See* Smith v. Van Gorkom, 488 A.2d 858, 876 (Del. 1985) ("[T]here was no call by the board . . . for any valuation study or documentation of the $55 price as a measure of the fair value of the Company in a cash-out context."). Though the court did say, "[w]e do not imply that an outside evaluation study is essential to support an informed business judgment, nor do we state that fairness opinions by independent investment bankers are required as a matter of law," *id.*, many have read the opinion as strongly tilting the Delaware law toward such a requirement.

[26] *See id.* at 869 (discussing a two hour board meeting based on oral presentation with merger agreement executed by Van Gorkom during a formal social event he hosted for the opening of the Chicago Lyric Opera).

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

[28] Scattered Corp. v. Chi. Stock Exch., 701 A.2d 70 (Del. 1997).

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

[30] *See* Broz v. Cellular Info. Sys., Inc., 673 A.2d 148, 158 n.10 (Del. 1996) (refusing to support Chancellor's decision below requiring formal presentation of corporate opportunity to the board but noting that "formal presentation to the board is often the preferred—or 'safe'—approach, and we note that this litigation might have been unnecessary had this precaution been observed"); *see also* Northeast Harbor Golf Club, Inc. v. Harris, 661 A.2d 1146, 1152 (Me. 1995) (adopting the ALI structure); PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 5.05 (1992) (requiring notice to the board).

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the transactions from being accomplished, an outcome that directors would want to avoid. Substantial litigation continues to occur over duty of care challenges to a transaction. More particularly, the Delaware Supreme Court in *Emerald Partners v. Berlin*[31] ruled that an exculpation clause is an affirmative defense that directors have the burden of establishing. Directors must negate all categories of the various exclusions the statute makes from the exculpation permitted in the statute.[32] More generally, statements such as those by Chancellor Allen in *Caremark* and *Gagliardi* proclaim the substance of a board's decision off limits to a judge, but judicial review of process continues to evolve nonetheless.[33]

In the aftermath of section 102(b)(7), the specifics of corporate practice in the *Van Gorkom* opinion may be better denominated as a norm, something that is closer to the division between standards of conduct and standards of liability that the drafters of the Model Business Corporation Act have adopted by using separate provisions for each (sections 8.30 and 8.31) in changes to the Act published in 1998.[34] The Official Comment to those sections notes that the first section deals with the level of performance expected of every director, but it does not automatically establish personal liability.[35] Indeed, section 8.31 incorporates an exculpation provision, in

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[31] 726 A.2d 1215, 1223 (Del. 1999).

[32] *See* William T. Allen, Jack B. Jacobs & Leo E. Strine, Jr., *Function over Form: A Reassessment of Standards of Review in Delaware Corporation Law*, 56 BUS. LAW 1287, 1304-05 (2001) ("Imposing the burden to establish the exculpation defense upon the directors perversely requires them to disprove all of the duty of *loyalty*-related exceptions to the defense to be relieved of liability for *due care* claims. That is not how the exculpation defense should work.").

[33] *See In re* Caremark Inc. Derivative Litig., 698 A.2d 959, 967 (Del. Ch. 1996).

> What should be understood, but may not be widely understood by courts or commentators who are too often required to face such questions, is that compliance with a director's duty of care, can never appropriately be judicially determined by reference to *the content of the board's decision* that leads to a corporate loss, apart from consideration of the good faith *or* rationality of the process employed.

Id. In *Gagliardi v. Tri-Foods Int'l, Inc.*, 683 A.2d 1049 (Del. Ch. 1996), Chancellor Allen wrote:

> [I]n the absence of facts showing self-dealing or improper motive, a corporate officer or director is not legally responsible to the corporation for losses that may be suffered as a result of a decision that an officer made or that directors authorized in good faith. There is a theoretical exception to this general statement that holds that some decisions may be so "egregious" the liability for losses they cause may follow even in the absence of proof of conflict of interest or improper motivation. The exception, however, has resulted in no awards of money judgments against corporate officers or directors in this jurisdiction .... Thus, to allege that a corporation has suffered a loss as a result of a lawful transaction, within the corporation's powers, authorized by a corporate fiduciary *acting in a good faith pursuit of corporate purposes*, does not state a claim for relief against that fiduciary no matter how foolish the investment may appear in retrospect.

Id. at 1051-52.

[34] *See* Committee on Corporate Laws, *Changes in the Model Business Corporation Act Pertaining to the Standards of Conduct and Standards of Liability—Final Adoption*, 53 BUS. LAW. 813 (1998); Committee on Corporate Laws, *Changes in the Model Business Corporation Act—Amendments Pertaining to Electronic Filings/Standards of Conduct and Standards of Liability for Directors*, 53 BUS. LAW. 157 (1997).

[35] MODEL BUS. CORP. ACT § 8.30 official cmt., § 8.31 official cmt. (1999).

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different words but with a scope similar to section 102(b)(7).[36]

The danger in relying too much on this aspirational part of corporate law is reflected in how Ira Millstein described the change brought about by *Van Gorkom*. Millstein observed, "If you ask any director today what is the one case he/she knows, it's *Van Gorkom*. I have never been in a board room where I couldn't get a director's attention by saying 'Remember *Van Gorkom*.'"[37] Millstein noted the dramatic change in the actions of boards of directors that could be attributed to *Van Gorkom*:

> [I]f you went into a board room before *Smith v. Van Gorkom* and tried to talk about legal obligations, they'd say, "We have more important things to do than to listen to you tell us about what we ought to be doing." When *Smith* came down, you were able to walk into a board room for the first time in my experience and really be heard. That was a good thing to have happen. Up until then it was more missionary work—talking about good and evil and how you really ought to do your jobs.[38]

Yet there is some chance that this effect extends only to those whose professional life extends back beyond 1985, people who could in some way personally feel the change brought about by *Van Gorkom*. More recent experience with directors of dot-com companies suggests little name recognition of the case.[39] In the absence of personal liability and personal experience with the case, the likelihood increases that more and more directors will again say "we have more important things to do than listen to you tell us about what we ought to be doing."

The procedural richness that has followed *Van Gorkom* is to some extent offset by the choreographed nature of the procedures that it has spawned. We have had a marked increase in the use of third-party advisers and other processes designed to gain the protection of the business judgment rule within the parameters of the *Van Gorkom* opinion. Yet these processes, arranged by lawyers for directors who face no personal liability if they do not do it right, have taken on the attributes of theater. Staged like a good play, a post-*Van Gorkom* board meeting often evokes simply a recitation of required emotions on the part of actors "that in the final analysis, when the stage lights dim, turns out to have only been an illusion," a classic triumph of form over substance.[40] At least as applied to duty of care deci-

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[36] For earlier calls for an aspirational approach, see John C. Coffee, Jr., *Litigation and Corporate Governance: An Essay on Steering Between Scylla and Charybdis*, 52 GEO. WASH. L. REV. 789, 798 (1984) (arguing that duty of care has "socializing and exhortative impact" and should be left intact because of its "aspirational" potential); *see also* Melvin Eisenberg, *The Divergence of Standards of Conduct and Standards of Review in Corporate Law*, 62 FORDHAM L. REV. 437, 437 (1993).

[37] Roundtable: The Legacy of *Smith v. Van Gorkom*, DIRECTORS & BOARDS, Spring 2000, at 3.

[38] *Id.*

[39] Transcript of Symposium, May 19, 2001 (on file with the authors).

[40] Charles M. Elson, *The Duty of Care, Compensation and Stock Ownership*, 63 U. CIN. L. REV. 649, 683 (1995).

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sions, there is reason to ask whether these additional procedures have stimulated more board oversight. It is possible, of course, that following these procedures does stimulate thoughtfulness, similar to how a norm fosters desired behavior. But the great performance-related corporation disasters of the 1980s and early 1990s that followed *Van Gorkom* should suggest that a procedure-based duty of care does not alleviate board passivity. Recent work by Professors Lynn Stout and Margaret Blair suggest actors, like directors, are more likely to demonstrate altruism when the costs of doing so are relatively low.[41] Similarly, the aspirational aspects of corporate law can have their greatest impact in a context where the directors have an economic incentive to act in a way that the aspirational rules seek.

III. INFLUENCING BOARD BEHAVIOR BY MEANS OTHER THAN LAW

Constraining board behavior via ex post judicial action based on fiduciary duty necessarily includes the risk that judges might get it wrong more often than we would like—because of a lack of information or barriers to transparency that block a judge's view of the parties' decisions and their reasoning. The business judgment rule embodies a deference to director decisions that seeks to avoid that kind of error.[42] As described by the dissenting opinion in *Van Gorkom*, the directors of Trans Union were not the caliber of directors ordinarily taken in by a fast shuffle.[43] In rejecting such deference, the focus on process in the *Van Gorkom* majority opinion seems directed toward markers that a court would be able to observe. But experience since *Van Gorkom* has shown that courts cannot distinguish the play-acting aspects of the *Van Gorkom* procedures from insufficient care in decision-making. This inadequacy is not the result of courts not doing their job but rather the inability of any third-party arbiter to have sufficient information to make this determination. In this setting, it makes more sense to use a pre-decision incentive structure that relies on the personal economic interest of the directors whose conduct we are trying to police instead of after-the-fact judicial sanction.

Such an incentive structure can be created by linking directors' personal wealth to their companies' success or failure.[44] We can do this by making them substantial shareholders, as they were in many American corporations in earlier periods, and as they still are in some closely held enter-

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[41] Margaret Blair & Lynn Stout, *Trust, Trustworthiness, and the Behavioral Foundations of Corporate Law*, 149 U. PA. L. REV. 1735 (2001); *see also* Lynn Stout, *In Praise of Procedure: An Economic and Behavioral Defense of* Smith v. Van Gorkom *and the Business Judgment Rule*, 96 NW. U. L. REV. 675 (2002).

[42] *See, e.g.*, Joy v. North, 692 F.2d 880, 886 (2d Cir. 1982) ("[C]ourts recognize that after-the-fact litigation is a most imperfect device to evaluate corporate business decisions.").

[43] Smith v. Van Gorkom, 488 A.2d 858, 894 (Del. 1985) (McNeilly, J., dissenting).

[44] R. Franklin Balotti, Charles M. Elson & J. Travis Lester, *Equity Ownership and the Duty of Care: Convergence, Revolution, or Evolution*, 55 BUS. LAW. 661 (2000).

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prises today (including venture capital firms in the stages prior to initial public offerings). For publicly held companies, this means paying directors in stock, a practice that has become common over the last five years. It can also include requiring director candidates to acquire stock upon taking office. Both practices align the directors with the company's owners; if they have a proprietary interest they will act more like proprietors.

In part, this reflects a choice of a carrot over a stick. The impact on directors will be greater if they are motivated to do the right thing by their own rational economic interest to exercise oversight, as opposed to motivation by threat of judicial sanction to avoid personal liability, particularly when the difficulty courts have in getting complete information means that the prescribed procedures end up being more play acting than devices that really improve decision-making. In relative terms, this is a recognition that equity-based incentives can more effectively change board behavior than procedures required and reviewed by courts.

How does the traditional duty of care fit into all of this? If aligning the economic incentives of directors with the corporation is more effective than external judicial sanction, law can have a role in how this alignment is implemented. Reliance on markets and private ordering might suggest letting market incentives push corporations to adopt for themselves such requirements. Alternatively, law might provide a default rule for such an incentive-based structure or encourage norms that achieve a similar result. Collective action problems, as well as the path dependence of the last century and a half of corporate law, suggest that duty of care will continue to be a part of corporate law.[45]

Given the importance of precedent and prior learning in this area, we prefer a combination that permits the traditional duty of care legal learning to incorporate the decision-making that comes from economic self-interest. Thus, directors who are disinterested and independent as to the particular decision being made, and who possess a substantial equity investment in the company would be presumed to have met their duty of care as set under traditional standards.[46]

Such an equity-based duty has been proposed by a report of the National Association of Corporate Directors Council.[47] Most members of the

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[45] For a discussion of path dependence, see generally S.J. Lebowitz & Stephen E. Margolis, *Path Dependence, Lock-in and History*, 11 J.L. ECON. & ORG. 205 (1995).

[46] Balotti, Elson & Lester, *supra* note 44, at 686 (suggesting that a director wishing to invoke the substantial equity ownership presumption must prove ownership of equity, having a value that is material "in the context of the director's economic circumstance").

[47] NAT'L ASS'N OF CORP. DIRS., REPORT OF THE NACD BEST PRACTICES COUNCIL, COPING WITH FRAUD AND OTHER ILLEGAL ACTIVITIES (1998) [hereinafter NACD REPORT]. Professor Elson served on the NACD Council. It was set up in 1997 to provide guidance and counsel to fast-growing, entrepreneurial companies. NACD includes 2000 members who are chairs of the board, chief executive officers, presidents, vice presidents, chief financial officers and others who serve on, or deal with, corporate boards of directors.

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Council believed that persons making decisions about their personal and financial assets engage in a reasonable process and reach reasonable decisions given their abilities and experiences. This is based on the intuitive belief that people act as rational economic beings seeking to increase their assets by taking prudent risks, and that such decisions are more likely to be good ones than decisions motivated only by avoidance of personal liability.

Delaware case law since *Van Gorkom* illustrates a growing willingness to rely on the stimulus of economic incentives. In *Van Gorkom* itself, the court was unpersuaded that Jerome W. Van Gorkom's 75,000 shares gave him sufficient incentive to get the best price. His impending retirement has sometimes been suggested as a conflict of interest, and that fact was noted by the court.[48] Apart from the resolution of that question, the other directors had holdings that were almost miniscule. Yet in the *Technicolor* case, involving a transaction in which the procedures (or lack thereof) of the board tracked closely the Trans Union deal, the court found that the actions were sufficient to meet the board's fiduciary duty.[49] The *Technicolor* transaction took place before the *Van Gorkom* decision even though the Delaware Supreme Court did not decide the liability question until ten years after *Van Gorkom*.[50] With a decade's worth of experience with the more intrusive rule (and a panel that included none of the *Van Gorkom* justices), the *Technicolor* court pointed to the equity ownership of the chief decision-makers as supporting entire fairness.[51] Similarly the Chancellor in ruling on the much-publicized Disney case and the very large compensation package approved for its president who served less than a year, pointed to the equity interest of director Roy Disney, "an economically rational individual whose priority is to protect the value of his Disney shares, not someone who would intentionally risk his own and his family interest to placate" the company's CEO.[52] The use of equity as an incentive in that case occurred in the context of refuting an alleged lack of independence. By similar reasoning, equity ownership can act to block additional judicial consideration of duty of

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[48] Smith v. Van Gorkom, 488 A.2d 858, 866 (Del. 1985).

[49] Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1156 (Del. 1995) (upholding the Chancellor's judgment that the transaction met the entire fairness test, though the court had only one of its five members available to sit on the panel).

[50] Indeed the litigation in the case continues as of this writing through numerous published opinions.

[51] *See Technicolor*, 663 A.2d at 1177 ("The Court of Chancery found the 'fact that major shareholders, including Kamerman and Bjorkman who had the greatest insights into the value of the company, sold their stock to MAF at the same price paid to remaining shareholders also powerfully implies that the price received was fair.'" (quoting Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1134, 1143 (Del. Ch. 1994)).

[52] *In re* The Walt Disney Co. Derivative Litig., 731 A.2d 343, 356 (Del. Ch. 1998), *aff'd in part and rev'd in part sub nom*, Brehm v. Eisner, 746 A.2d 244 (2000); *see also In re* IXT Communications, Inc. v. Cincinnati Bell, Inc., No. C.A. 17324, 17334, 1999 WL 1009174, at *5 (Del. Ch. 1999) ("It bears noting that GEPT's representation on the board and [three] Directors . . . collectively represent the economic interest of 30% of the company's stock directly as well as the entire community of shareholders indirectly.").

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care claims.

The effect of the presumption would be to eliminate questions not just about the substance of the board's decision but also its process in arriving at a decision. Equity rather than process would do the heavy lifting in constraining director action. The presumption would attach only as to duty of care issues, when after-the-fact judicial review seems to have less of a relative advantage as compared to other possible constraints on director action. It would attach only to directors who are not financially interested in the specific transaction at issue and who are independent of management so that they are capable of making decisions in their economic interest without undue outside influence. There is extensive Delaware case law on self-dealing and independence such that there is a greater perceived relative advantage for courts to make such a decision as well as less reliability in relying on self-help of the conflicted set of directors.

The presumption should only be available if a majority of the board has equity ownership. In *Aronson*, the Delaware Supreme Court adopted a similar dividing line in deciding whether to apply the presumption of the business judgment rule when the board of directors contends that the plaintiff must make a demand on the board before commencing a derivative action.[53] The court held that if a majority of the board is disinterested and independent, demand must be made on the board of directors. If a majority of directors choose not to pursue equity ownership, a duty of care challenge would remain subject to the traditional duty of care regime, which includes the traditional defenses of the business judgment rule. In this respect, the presumption arising from equity ownership differs somewhat from the long-standing presumption of the business judgment rule that is the linchpin of Delaware law, in that actors must make a more direct choice to take advantage of the equity presumption by opting in to equity ownership of directors. The practical result would be to reduce the importance of traditional duty of care discussions in favor of this focus on equity.

While it would be possible to rely exclusively on the equity incentive approach, experience in the development of procedure-based duty of loyalty cases suggests the benefit of a judicial "failsafe" that would be available for egregious cases that seemingly meet the equity standards. Toward this end, a showing that directors acted contrary to their equity interest or that damage resulted from a sustained and systemic failure of the directors to oversee the enterprise could rebut the presumption.[54]

This reliance on equity ownership over judicial monitoring raises the

[53] Aronson v. Lewis, 473 A.2d 805, 815 n.8 (Del. 1984) ("We recognize that drawing the line at a majority of the board may be an arguably arbitrary dividing point.").

[54] This echoes the language of *In re Caremark International Inc. Derivative Litigation*, 698 A.2d 959 (Del. Ch. 1996), a duty of care case settled prior to judicial ruling on defendant's motion to dismiss that was based on two grounds, including the section 102(b)(7) exculpation provision in the company's charter.

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question of whether this choice does in fact create better monitoring. An exact comparison is difficult, as is measuring the benefit from judicial monitoring. But there is empirical evidence to suggest a connection. First, studies on executive compensation and corporate performance suggest that where director stock ownership is higher, executive compensation is better related to performance, and overall corporate performance is better. Second, greater equity of outside directors has been linked to a board-induced executive turnover in poorer performing companies.[55]

This evolution away from a constraint that relies primarily on after-the-fact judicial action toward one that relies on the incentives and private ordering of the parties is neither surprising nor unusual. Oliver Williamson has observed that "court ordering is a very crude instrument"[56] that is not likely to be the preferred choice of participants where incomplete contracting problems exist. Typically, the parties will not trust judges to grasp sufficiently the performance and relationship of the parties so as to be better able to resolve conflicts than the parties could themselves.[57] The legislative response to *Van Gorkom* reflects a widespread recognition of the risk of error inherent in judicial resolution in duty of care settings. Thus, equity substitutes economic incentives that the parities will find more reliable.

Van Gorkom is not the only situation in which the relative weaknesses of ex post judicial monitoring have become visible. *Unocal*, decided by the Delaware Court later the same year as *Van Gorkom*, reflects a similar challenge for after the fact judicial ordering. Like *Van Gorkom*, in *Unocal* there were none of the traditional indicia of self-interest or bad faith that would trigger anything other than deference by the court to the decisions of the board. Because of the "omnipresent specter" of self-interest that hovers around the actions of the directors of a target board taking defensive tactics to fend off an unwanted suitor,[58] the court announced an approach featuring enhanced judicial scrutiny which stopped defendants at the threshold before they got to the deference of the business judgment rule and required them first to prove that there was a threat and that their defense was proportional to the threat.[59]

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[55] *See generally* Balotti, Elson & Lester, *supra* note 44.

[56] OLIVER WILLIAMSON, THE MECHANISMS OF GOVERNANCE 176-77 (1996).

[57] More generally, this suggests why participants will bring activities inside of the firm and rely on governance structures instead of judicial enforcement of contract rights. It can also explain why participants would prefer self-help and incentives that make self-help an alternative to after-the-fact judging. *See id.* at 176-77 ("Rather than assume that disputes are routinely submitted to and efficaciously decided by the courts, [transaction cost economics] maintains that court ordering is a very crude instrument and that most disputes, including many that under current rules could be brought to account [can be] resolved by avoidance, self-help and the like.").

[58] Unocal, Inc. v. Mesa Petroleum Co., 493 A.2d 946, 954 (Del. 1985).

[59] *Id.* at 955. In *Unocal*, the court used the term "enhanced duty," *id.* at 954, but quickly modified its terminology in *Revlon* to "enhanced scrutiny," Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 184 (Del. 1985), which seems to capture more precisely the judicial role that is at issue.

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This after-the-fact judicial scrutiny has proved little more effective than the scrutiny provided by *Van Gorkom*, but through an entirely different process. No legislative action occurred and no change in the legal regime was announced, but even as the courts applied the enhanced scrutiny, the results reveal a slide back toward deference. After fifteen years, *Unocal* is seldom used, and it almost never results in a defensive tactic being thrown out by the court.[60] As applied by Delaware courts, the enhanced scrutiny of the *Unocal* rule looks remarkably similar to the business judgment rule deference. As evidenced by the Delaware Supreme Court's decision in *Unitrin*, where the court refused to block defensive tactics:

> The *ratio decendi* for the "range of reasonableness" standard is a need of the board of directors for latitude in discharging its fiduciary duties to the corporation and its shareholders when defending against perceived threats. The concomitant requirement is for judicial restraint. Consequently, if the board of directors' defensive response is not draconian (preclusive or coercive) and is within a "range of reasonableness," a court must not substitute its judgment for the board's.[61]

The reasons for the diminished impact of *Unocal* parallel somewhat the reasons why *Van Gorkom* itself has been cut back by statute. Judges have a difficult time differentiating takeover actions that are bad for shareholders from those that are good. As Easterbrook and Fischel have observed, "there is no signal that separates intransigent resistance from honest effort to conduct an auction for the shareholder's benefit."[62] Courts do not relish the task of evaluating the fairness of a business decision; they would rather focus on the decision-making process. Yet the focus on process in a challenge to a takeover defense will not enable courts to pick out those situations in which shareholders believe that directors are inappropriately blocking a transaction that the shareholders would like to accept. In such a situation, a non-judicially enforced right is more likely to achieve the parties' goal. In a *Unocal*-type situation, this would be a greater use of shareholder self-help to decide when to override director defensive tactics, one that relies on shareholder voting instead of judicial decision to remove director defenses.[63] This would include, for example, a binding shareholder resolution to remove a poison pill, or a mandatory shareholder bylaw to overcome director-induced defensive tactics that block action within share-

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[60] *See* Robert B. Thompson & D. Gordon Smith, *Toward a New Theory of the Shareholder Role: "Sacred Space" in Corporate Takeovers*, 80 TEX. L. REV. 261, 263 (2001) (showing that the use of *Unocal* has decreased to about one case per year in the 1990s from about 3.5 cases per year in the 1980s, even though takeovers have remained in the same range, and that the doctrine is almost never used by the Delaware Supreme Court to strike down a defensive tactic).

[61] Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d 1361, 1388 (Del. 1995).

[62] Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161, 1175 (1981).

[63] *See* Thompson & Smith, *supra* note 60 (describing "sacred space" within which shareholders are free to act via self-help to override defensive tactics of directors).

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holder sacred space.

CONCLUSION

Thomas Jefferson's observation of the need for a rebellion every twenty years[64] reflects a recognition of the constant adaptability that occurs in our society. The rules in place at one point may no longer fit for the next generation. *Van Gorkom* was a landmark case using law, and particularly fiduciary duty applied by judges after the fact, to prod passive boards into a greater monitoring role. Yet law is one of many possible constraints on director action that can affect corporate governance, and the relative advantage that it may have in a particular context and a particular time may not carry forward to a new setting. Such is the case with *Van Gorkom.*

Van Gorkom was a well-intentioned, though ultimately misdirected, attempt to reinvigorate a hitherto passive directorship. By focusing on the procedural rather than the structural, the court created a regime in which form dominated substance, a regime that produced an artificial decision-making process that enhanced only the wealth of the board's third-party advisors rather than the directors' principals—the shareholders. Both the institutional investor community and the Delaware courts have begun to recognize this regime's shortcomings, and we have witnessed a new focus on creating better director oversight and decision-making through structural reform in the composition of the board. The emphasis is now on the creation of an independent, equity-holding directorship that will have the internal motivation to act effectively. Independence gives the board the objectivity to oversee management and its activities. Equity ownership gives the board the incentive to exercise that objectivity. Law, through judicially enforced fiduciary duty, creates the boundaries for conduct, but it is the composition and proprietary interest of the board that provides the impetus for effective oversight and decision-making. Therefore, as our views of how to create a responsible directorship have changed, so must the legal context in which the board operates. *Van Gorkom*, with its emphasis on procedure, must give way to a new regime predicated on director independence and equity ownership. In a legal climate focused on enlightened self-motivation, boards will finally reclaim their role in the corporate form that will truly inspire shareholder confidence, investment, and ultimate corporate success.

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[64] Letter from Thomas Jefferson to James Madison (Jan. 30, 1787), *quoted in* JEFFERSON HIMSELF, THE PERSONAL NARRATIVE OF A MANY SIDED AMERICAN at 43 (Bernard Mayo ed., 1970) ("I hold that a little rebellion now and then is a good thing and as necessary in the political world as storms in the physical.").

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