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Federalizm vs. State law in the regulation of corporations: A conflicting or complimentary shift in corporate jurisprudence? How Delaware has responded

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The essence of this paper is to analyze how federal corporate law has shaped Delaware State’s corporate law jurisprudence. I argue that recent federal engagement in corporate law should be welcomed and sustained by congress when state corporate law rules fall short in providing adequate protection for investors. Using a small number of case law, it will be acknowledged as we develop this paper that Delaware’s corporate law has had a fundamental shift in the wake of Enron and WorldCom and the advent of the Sarbanes-Oxley Act, 2002. At the same time we will also show how Delaware has held fast to well established principles of corporate law and also show that congress can effectively influence state law through legislation that does not completely preempt state law.

Analysis of the paper is sub-divided into the Pre Enron period and Post Enron era in order to clearly differentiate the judicial shifts in decision making by the state courts of Delaware during these distinct periods.

The discussion of this paper is divided into four parts. Part One is the Introduction and we will briefly examine the different arguments of corporate federalist’s vis-à-vis State law advocates. To understand and distinguish Federal law from State law and in order to make an informed evaluation of how one has influenced the other (if at all), an analysis of both is absolutely necessary.

Therefore, Part Two begins with an analysis of Delaware’s corporate regulations and their application by the State courts. Part two thus begins with the Pre Enron Period
where we examine Delaware’s traditional “triad” of fiduciary duties. The first in
discussion is the Fiduciary duty of care and the business judgment rule. Under this title
we discuss Directors responsibilities for oversight and delegation of functions. Secondly
we look at Delaware’s duty of Loyalty, under which we discuss interested director
transactions and corporate opportunities. We also examine the role of Delaware’s
procedural protections in limiting director liability. The protections discussed
are the demand requirement and the use of special litigation committees to deny
shareholder’s a chance to litigate otherwise meritorious claims. Lastly under this part we
discuss the ambiguous duty of good faith especially as was applied as part and parcel of
the fiduciary duties of care and loyalty.

Part Three delves into Federal regulation such as SRO’S, although our emphasis will be
on the Sarbanes Oxley Act, 2002. We examine how federalism has crept into a state
domain. Pertinent and relevant sections of the legislation such as the new definition of
director independence and the mandatory requirement to establish an audit committee are
analyzed. Also under this part, using a few Post Enron Delaware decisions, we show the
jurisprudential shifts that have occurred on the application of state law in shareholder
claims against director in the wake of the Corporate scandals of early 2000’s and
Sarbanes Oxley.

Lastly, Part four, is the recapitulation and conclusion that summarizes all the considered
points with a suggestion that while the readers are left to decide on their own, one could
suggest that Delaware Corporate Jurisprudence has not changed much but rather it is the
shareholders expectations that have changed expecting more from their directors.
1.) Introduction: Federal vs. State law Arguments

“If we don’t fix it, Congress will, but I hope they’ve gone as far as they’re going to have to go”¹ This statement by one of America’s most respected jurists forms part of an on going effort to retain the state of Delaware’s legitimacy and power in the realm of corporate law, in the face of recent federal encroachments on state law territory. Delaware Supreme Court Chief Justice made this statement in the wake of recent corporate scandals and Congress’ subsequent adopting of Sarbanes – Oxley Act of 2002.² To some, Sarbanes-Oxley represents an ill advised advance in the “creeping federalization of corporate law”³ To others; they think that a realistic threat of federalization is necessary to ensure the robust development of corporate law at state level.⁴ Their argument is that Delaware enjoys a monopoly position in the market for “Out-of-state” incorporations. This means that little pressure actually comes from other states which might push Delaware to shape its corporate law to increase protections for shareholders and other constituent groups. According to them, federal government can serve as a credible rival to Delaware. The Sarbanes-Oxley Act’s apparent influence on Delaware corporate law suggests the potential for a dynamic relationship between state and federal regulation of corporate conduct. Recent Delaware court decisions indicate that Delaware’s judiciary has began to respond to this preemptive threat by adjusting its corporate law jurisprudence. The courts appear to be moving to more restrictive application of the business judgment rule and more vigorous enforcement of officer’s and

³ Stephen M. Bainbridge, The creeping Federalization of Corporate law, Regulation, Spring, 2003, at 26
⁴ Renee M. Jones; Rethinking Corporate federalism in the Era of Corporate reform, Corporate Practice Commentator at 38
fiduciary duties. This jurisprudential shift demonstrates that Congress can effectively influence state law through legislation measures that do not require complete preemption of state law.\(^5\)

The Sarbanes-Oxley Act has been described as “the most far-reaching reforms of American corporate practices since the time of Franklin Delano Roosevelt.”\(^6\) In the present federal system of corporate law, state governments set the rules governing the relationships among the primary participants in the corporate enterprise; Directors, officers and investors. Each state has its own corporate statute and a corporation may incorporate under the laws of any state, regardless of whether it owns assets or conducts operations in that state. Under the “internal affairs doctrine,” it is the law of the selected state that governs all disputes regarding a corporation's internal affairs, regardless of the forum in which such disputes are litigated.\(^7\) Because Corporations pay franchise taxes and other fees to the states in which they incorporate, many commentators have argued that states compete for corporate charters and the tax revenues they generate.\(^8\) That more than half of all publicly traded corporations incorporate in Delaware leads most to conclude that Delaware has “won” this competition.\(^9\) Corporate federalists have argued that national regulation would disrupt this competition process because the federal government would enjoy monopoly power, nullifying the ability of competitive forces to advance optimal legal rules.\(^10\) That is why opponents of national level regulation argue that such

\(^{5}\) Id.
\(^{6}\) Elisabeth Bulmiller, *Bush signs Bill Aimed at Fraud in Corporations*, N.Y. Times, July 31, 2002 at A1
\(^{7}\) Restatement (second) of Conflicts of Laws section 302 (1971)
\(^{10}\) Roberta Romano, *Law as Product: Some pieces of the incorporation Puzzle*, 1 J.L. Econ & Org. 225 at 281 (1985)
regulation would not likely do better than state law in the protection of shareholders as Congress is just as susceptible to business lobbying as state legislatures. But those on the other side say that federal engagement provides voters throughout the country an opportunity to persuade Congress to preempt those state law provisions that lack popular support. This dynamic allows investors to influence state corporate law, if only indirectly. A posture of absolute federal deference to state regulators would deprive citizens of this power enhancing management’s dominance of the state regulatory process.

In summary, allowing states to continue to regulate corporations appears to offer some benefits over a purely federalized scheme yet states should not enjoy exclusive authority in this realm, congress can influence state corporations without pre-empting it entirely. Therefore a practical resolution for corporate reform seems to be closer congressional scrutiny of corporate regulation, aided by limited preemption when necessary to correct the states propensity to place the interests of managers above other corporate constituents in crafting corporate law.

The widespread corporate governance scandals revealed in the late 2001 through 2002 prompted broad scrutiny of corporate law and launched Congressional hearings on corporate reform. Therefore, the scandals – Enron and WorldCom- serve as a convenient dividing line for an analysis of pre and post Enron trends in judicial decision making.

This paper reviews the state of Delaware law before Enron and identifies the legal doctrines that made it difficult for share holders to enforce the fiduciary duties officers, directors, and controlling shareholders that are at the heart of corporate law.

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11 id at 230
12 Renee M. Jones: Rethinking Corporate federalism in the era of corporate reform, Corporate practice commenter see fn.4 at 16
13 Id.
2.) Delaware’s Corporate Regulation: Pre-Enron

Corporate fiduciaries were initially subject to two traditional fiduciary duties: the duty of care and the duty of loyalty. These were the two main duties these corporate fiduciaries owed the beneficiary constituencies in corporations. Recently a new form of fiduciary duty has been curved, that is the fiduciary duty of good faith. Although there has been some mention of Delaware’s “triad” of fiduciary duties: the duties of care, loyalty and good faith, historically, Delaware cases discussed good faith as part of an analysis of the duty of care or the duty of loyalty. Some opinions suggest that good faith is a component of the duty of care. According to the Chancery Court a Directors “good faith effort to be informed and exercise judgment” is a core element of the duty of care. It is clear from pre-Enron judicial decisions that even before the spectacular corporate scandals of the recent years, the Delaware courts were setting the stage to develop more refined, higher standards of director conduct thorough their analysis of “good faith”. In the wake of the scandals, directors who fail to pay attention to the developing guidance offered by the Delaware courts in cases like In re Walt Disney Co. Litigation may expect to see more scrutiny, and possibly personal liability, imposed on them and the processes by which they govern corporate activity. This paper will also discuss how the fiduciary duty of good faith has evolved from being a part of either of the other fiduciary duties of Care and Loyalty to a more prominent and substantive duty standing on its own.

15 In Re Caremark International Inc. Derivative Litigation,698 A.2d at 968.
A.) DELAWARE’S DUTY OF CARE (IN DECISION-MAKING AND RELIANCE ON REPORTS AND OTHER INFORMATION) VIS-À-VIS THE BUSINESS JUDGMENT RULE SHIELD

Under Delaware’s fiduciary duty of care, directors must act in good faith, with the care of an ordinary prudent person, and in the best interests of the Corporation. It is important to focus on two discrete areas of potential liability exposure for directors in failure to exercise due care. The first is the failure to exercise the requisite degree of care in the process of decision making – that element of the business judgment rule which requires the directors to act on an informed basis. The second is the requisite duty of care in all aspects of the directors’ responsibilities other than decision making including the delegation and oversight functions. The business judgment rule is a common law principle of corporate governance that, has been part of the corporate law for at least 150 years. The business judgment rule has traditionally operated as a shield to protect directors from personal liability for decisions made by them. In Delaware, “to invoke the business judgment rule’s protection directors have a duty to inform themselves, prior to making a business decision, of all material information reasonably available to them. Having become so informed, they must then act with requisite care in the discharge of their duties. While Delaware cases use a variety of terms to describe the applicable standard of care, our analysis satisfies us that under the business judgment rule director liability is predicated upon concepts of gross negligence.”

While courts and legislatures have expressed the standard of care for directors in many ways, most expressions fix upon the “traditional standard”, expressed as the “ordinary

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18 Arsh, Business judgment Rule Revisited, 8 Hofstra L. Rev. at 93
19 Aronson vs. Lewis, 473 A.2d. 805, 812 (Del. 1984)
prudent person under similar circumstances.” Some commentators do not agree however, upon the level of care required by such standards. Some authorities maintain that the prevailing test is one of ordinary care imposing liability for its correlative – ordinary negligence. Other authorities maintain that the prevailing standard is gross negligence. Delaware has no Statutory provisions setting forth the standard, but the dictum in the 1963 Supreme Court case of Graham vs. Allis-Chalmers Manufacturing Co. sets forth a general standard of care: “Directors…in managing the corporate affairs are bound to use that amount of care which ordinarily careful and prudent men would use in similar circumstances.” Later case law has established that the Delaware standard is Predicated on “concepts of gross negligence” at least with respect to the requisite duty of care in the process of decision-making. In 1984, the Supreme Court of Delaware stated in Aronson vs. Lewis that, in the context of decision –making, directors are presumed to have acted “on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.” Thus the business judgment rule applies if the directors have informed themselves “prior to making a business decision, of all material information reasonably available to them” and that “…having become so informed, they must then act with the requisite care in the discharge of their

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20 Graham Vs. Allis-Chalmers Mfg. Co. 188 A.2d 125, 130 (Del. 1963) See also Dyson, The Directors liability for Negligence, 40 Ind. L.J. 341, 345 (1965)
21 id. at 371
22 3A W. Fletcher, Cyclopedia of the law of private Corporations 28-31 (rev. perm.ed.1975) Professor Dyson questions the utility of such an observation, though given the uneven applications of notions of “gross” and “ordinary” negligence”. Dyson, N. 222 supra, 40 Ind. L.J. AT 371, 375
24 Graham vs. Allis-Chalmers Mfg. Co., FN 17 supra, 188 A.2d 125
25 id. at 130
26 Aronson vs. Lewis FN.20 supra, 473 A.2d at 812
27 id.
duties.” It is important to keep in mind that the business judgment rule is not a standard of conduct but a tool for judicial review. The process of decision-making is however governed by a standard of conduct. Concluding that “under the business judgment rule director liability is predicated upon concepts of gross negligence,” the Aronson court articulated the standard applicable to the methodology of the directors in fulfilling the informational component of their duty to exercise their business judgment on an informed basis in making decisions. It is important to note however, that the concepts of gross negligence expressed in Aronson court do not apply to judicial review of the Boards substantive decision itself.

Directors are not expected to know everything about the business of the corporation or about a given transaction which management is contemplating. Nevertheless, they are expected to have a reasonable amount of knowledge of the company’s activities. Moreover, they are expected to reach an adequate level of understanding of all the material facts necessary to make a business judgment on a particular transaction. How much knowledge they are expected to have in either area is the subject of considerable debate in connection with the discussion of the director’s duty of care.

Section 141(e) of the Delaware General Corporations Law provides that a member of the Board of Directors or a member of a committee “shall, in the performance of his duties, be fully protected in relying in good faith upon books of account or reports made to the corporation by any of its officers, or by an independent public accountant, or an appraiser selected with reasonable care… or in relying in good faith on other records of the

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28 Id.
30 Aronson vs. Lewis FN 20 supra, 473 A.2d at 812
31 Smith vs. Van Gorkom, 488 A. 2d 858 (Del. 1985)
corporation.” Although this provision does not expressly include reports of non-officer employees, board committees, counsel or other experts (as does the corresponding provision in the RMBCA)\(^{32}\), the lack of such specificity in the General Corporation Law does not pose a practical problem.\(^{33}\)

Section 141 (e) is intended to be a safe harbor. The statute provides on the face of it that reliance must be in good faith and not unreasonable. It is recognized that the management is often the best informed source of the business of the company and opportunities which may confront the company.\(^{34}\) Protected reliance on officer’s reports, when those reports are credible on their face, is a necessity for practical functioning of the board of directors. Thus, a director in relying in good faith in reports or those reports or those of outside experts should be entitled to the full protection of the business judgment rule. Delaware cases have held that section 141(e) provides broad protection if the material relied upon constitutes a valid “report” within the meaning of that section.\(^{35}\) A director is not protected in relying upon a report which patently lacks substance or if the person giving the report is obviously uninformed on the essential provisions of the very

\(^{32}\) Section 8.30(b) Revised Model Business Corporations Act- RMBCA

\(^{33}\) Smith vs. Van Gorkom fn.28 supra, 488 A.2d at 872, specifically affirming the presumption that such reliance may be placed upon reports

\(^{34}\) Bayless Manning, writing about the proper scope of statutes, has pointed out that such statutes should be: Realistic in their recognition that directors may safely rely upon officers and employees of the corporation, accountants, engineers, lawyers and other expert consultants who they have reason to believe are competent. Expert consultation inspired by a perceived need to know on the part of the board is obviously constructive and indispensable. An inoculation of expert outside opinion is also of help in preventing an epidemic of liability in the board room. The law has also become more realistic in recognizing that such a board’s work is, and must be, done in committee and in according to the board the privilege of reliance upon the work product of its committees.

Manning, The Business Judgment rule and the Director’s Duty of Attention: Time for Reality, 39 Bus. Law. 1477,1487. See also Smith Vs. Van Gorkom, fn.28 supra, 488 A.2d at 874-75

\(^{35}\) Michelson vs. Duncan, 386 A.2d 1156 (Del. Ch. 1978), aff’d in part and rev’d in part on other grounds, 407 A.2d 211 (Del.1979); Graham vs. Allis-Chalmers Mfg. Co.,41 Del. Ch. 78, 188 A.2d 125. 130 (Del. 1963); Prince vs. Bensinger, 244 A. 2d 89, 94
document being presented. Moreover, the document must be relevant to the purpose for which the director relies (e.g., a valuation study). Thus in order for a director to rely on a “report” the reliance must be good faith reliance and not a blind reliance. An excellent example of the extent to which reliance on experts may be placed under Delaware law is Rosenblatt vs. Getty Oil Co., where the Supreme Court of Delaware upheld under Section 141 (e) the delegation of subsurface asset valuations to a world recognized petroleum expert for the purposes of establishing merger terms.

In 1985, the Supreme Court decided in Smith vs. Van Gorkom (The “Trans Union” Case) that Trans union’s directors were grossly negligent in their evaluation process of a merger proposal and in their recommendation to the shareholders for approval. The Directors were denied the protection of the business judgment rule and were held personally liable for any damages resulting from their action. Specifically, the Court held that the plaintiff has successfully demonstrated that the board decision was uninformed, thereby rebutting the presumption that the business judgment rule was an informed one. Liability was found even though there was no self dealing. The facts of this case are set forth as follows; Van Gorkom, the chief executive officer of Trans Union decided in 1980 that Trans Union should combine with a larger enterprise to take maximum advantage of the company’s large tax write-offs. Van Gorkom approached a third party, Pritzker, with a proposal for Pritzker to buy the stock in Trans Union for $55 a share, a price which Van Gorkom thought was fair. Pritzker soon made an offer based on Van Gorkom’s proposal,

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36 In Smith vs. Van Gorkom, fn 28 supra, 488 A. 2d at 875, the directors were not entitled to rely on an informal report of the officer presenting a merge proposal because it lacked substance. The court held the presenter was uninformed and the document was irrelevant to the issues before the board.
37 Rosenblatt vs. Getty Oil Co., 493 A.2d 929, 942-44 (Del. 1985)
38 Id.
and Pritzker’s offer was presented to Trans Union’s board one week after Van Gorkom first met Pritzker. Although management opposed the proposal, the Board eventually accepted it and agreed to submit the merger agreement to the requisite shareholder vote, subject to what they believed to be Trans Union’s right to accept any intervening better offer. After certain key person’s in management threatened to leave, Pritzker agreed to allow Trans Union to retain Salomon Brothers to solicit higher offers. After three months, without any success in finding a better offer, the Shareholders approved the merger agreement and the merger was consummated. The proposal which was presented to Van Gorkom by Pritzker on September 18, 1980 had a very short response time deadline, requiring a response by September 21. On September 19, Van Gorkom retained outside counsel, and on the next day a board meeting was held preceded by a management meeting earlier in the day. Only two members of senior management knew in advance the purpose of the management meeting. In fact, inside counsel was not told in advance. No Member of the board (other than management) had advance knowledge of the purpose of the board meeting. The chief financial officers (Romans) expressed his view that $55 was too low at the management meeting but not at the board meeting, and Van Gorkom never told the board that he originally had suggested $55. The company’s regular investment banker was not asked to render an opinion. The board relied on Van Gorkom’s 20 minute oral presentation. No question was asked of Van Gorkom or Romans. No one asked for more time or an extension of the September 21 deadline. The entire board meeting took only two hours. No papers were presented and the agreement as signed (during a concert at the opera) was not fully read and understood by the key

39 See Smith vs. Van Gorkom fn 28 supra, 488 A.2d at 870
40 Id.
decision makers and did not reflect all that the directors had contemplated. The court found the boards hasty action was taken without supporting staff work, without investment banking opinions, and without complete understanding of the terms of the merger agreement.\(^{41}\)

The court stated:

> Considering all of the surrounding circumstances—hastily calling the meeting without prior notice of its subject matter, the proposed sale of the company without any prior consideration of the issue or necessity therefore, the urgent time constraints imposed by Pritzker, and the total absence of any documentation whatsoever—the directors were duty bound to make reasonable inquiry of Van Gorkom and Romans and if they had done so, the inadequacy of that upon which they now claim to have relied would have been apparent.\(^{42}\)

The case was remanded to determine what damages if any, resulted from their action, and was subsequently settled.\(^{43}\) One lesson of *Trans Union* is that the price of giving deference to the business judgment rule of the directors and the consequent protection from liability under the business judgment rule is that the board must do its homework thoroughly and deliberately in its decision-making processes.

A few more lessons to learn from this case are\(^{44}\):

> Haste in decision making: Taking action in undue haste is inviting trouble when

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\(^{41}\) Id. at 875
\(^{42}\) Id.

\(^{43}\) Id. at 893 The directors were held liable for a breach of fiduciary duty, and action remanded to the court of chancery for an assessment of damages bring the difference between the $55 per share price and the fair value of Trans Union stock.

\(^{44}\) Balotti, Finkelstein and Abrams, “The role of business judgment rule in corporate control contests,” (Feb. 11,1985); Dynamics of Corporate control II: Evolving legal standards applied to frontiers of corporate strategy. Sponsored by ABA section of corporation, banking and business law at pg. 51
decisions are to be reviewed by Delaware courts. Certain directors of a target board in a hostile tender offer must act quickly and the courts understand that. Trans Union was not such a case, however. There Pritzker, for his own reasons imposed such a short deadline. Certainly the value offered was not so clearly advantageous that the directors would have been so foolish to have bargained for more or asked for an extension. Indeed, there was a strongly-held inside view that the price was too low. The courts rhetorical question seems to be; what’s the hurry?

Lack of Board preparation: No materials were distributed and no information was furnished in advance of the crucial board meeting. An artificial paper trail is not appropriate, but in most cases there will be time (or time should be taken) to obtain written material for the board to deliberately consider.

Lack of questioning or involvement by the board: The board (for the most part) did not know the substance of the 20 minute presentation by Van Gorkom in advance and it cannot be presumed that they were acting in a wealth of stored information at their fingertips. Yet apparently there are no questions.

Lack of paper record, reliance on officers or experts: Normally, directors are “fully protected in relying in good faith” under section 141 (e) on reports of officers or outside experts. Here the court found the report was not informed, the board did not exercise good faith in relying on it and no steps were taken to assure that the report of Van Gorkom was adequate. Moreover, there was no valuation information and no investment banker’s opinion. While the board asserted that it had views on the value of the company, there was no clearly demonstrated expertise brought to bear in the boardroom in that two hour meeting.
Lack of Care in Dealing with documents: The merger agreement itself was not available at the time of the board’s decision. Negotiating and drafting details may be delegated, but before the board’s decision is made the essential terms of the deal should be understood by them and the chief executive officer or some duly delegated officer or board committee should thoroughly understand the terms of the agreement. The lack of information in *Trans union* and the overall lack of knowledge of the terms of the agreement led to a finding of gross negligence.

There was a good example under Delaware Law of the court’s deference to proper methodology of the board in decision-making. In *Moran vs. Household International, Inc.* and *Elderman vs. Philips Petroleum Co*, the boards acted deliberately and responsibly, engaging in lengthy planning processes. Their careful methodologies enabled them to place the legal effect of the substantive decision in the best light for court review. Less than four months after the *Trans Union* decision, the Supreme Court of Delaware decided *Unocal Corp vs. Mesa Petroleum Co.* In *Unocal*, there was an issue raised about the lack of due care exercised by the Unocal Board in making hasty, significant and costly action to thwart a tender offer. The court held that the Business Judgment rule protected Unocal’s self tender exchange offer (which discriminatorily excluded the stock of the bidder), implicitly rejecting the fairness issue upon which Vice Chancellor Berger had preliminarily enjoined the exchange offer. The vice chancellor found that, although the Unocal board had acted with slightly less haste and had the benefit of more information than did the *Trans Union* board, the board’s imperfect

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45 490 A.2d 1059 (Del. Ch. 1985)
46 C.A No. 7899 (Del. Ch. Feb. 12, 1985)
47 493 A.2d 946 (Del. 1985)
48 Mesa Petroleum co. vs. Unocal corp., C.A. No. 7997, slip op at 20-21 (Del. Ch. 1985)
process of communicating by telephone conference call did not invalidate its action.

Although the Vice Chancellor preliminarily enjoined the Unocal board on a basis other than lack of due care, she did not find gross negligence in the process employed by the target board.\footnote{Id., C.A. No. 7997, fn.48 supra, at 21} The Supreme Court brushed aside arguments that the hasty action of the Unocal board ran counter to the due care requirements of \textit{Trans Union}.

In the end, the court’s decision of each case will depend on the procedural setting and all facts, but directors must be cautioned to scrutinize the transaction as critically as practicable under the circumstances, take as much time as feasible and consider all the information reasonably available.

\textbf{i) Directors’ Responsibility for Oversight and Delegation of Functions as Part of the Board’s Duty of Care}

A corporation can act only through its agents.\footnote{Guthridge vs. Pen-mod, Inc., 239 A. 2d 709 (Del. Super. 1967)} Officers are the principal agents of the Corporation, and normally it is the officers to whom the primary functions of management are delegated. There may, of course, be delegation to other agents, outside experts, independent contractors or non-officer employees.\footnote{Delaware General Corporation law (DGCL) section 122 (5)} The officer’s may be prescribed in the by-laws or they may be set forth in the resolution by the board. Any such resolution must not be inconsistent with the by-laws, the certificate of incorporation or the Delaware General Corporation Law (DCGL). Persons elected or appointed to fill those offices are selected by the Board and absent a contract, serve at the pleasure of the board.\footnote{Id. at section 142 (a) – (e)}
Unless otherwise provided by the certificate of incorporation and subject to the limitation on delegation set forth in the DGCL, a board of directors may delegate the management of the business and affairs of the corporation. Under Section 141 of the DGCL, a board may not delegate a specific function or duty which is by statute or the certificate of incorporation expressly assigned only to the Board. Thus in Clarke Memorial College vs. Monaghan Land Co., the court held that the board of directors could not delegate to officers the responsibility of fixing the terms and conditions of a sale of assets because under Section 271 of DGCL such a determination is expressly a duty to be fulfilled by the board. Likewise, in Field vs. Carlisle Corp., the court held that the board of directors may not delegate the duty of determining the value of property acquired as consideration for the issuance of stock because section 152 of the DGCL provides that such duty is expressly assigned to the board.

Nevertheless, most corporations are run by officers on a daily basis. Their functions and powers are often implied from course of conduct, rather than being expressly granted. Decision-making is one of two principal functions of directors. The other is “oversight”. It is therefore clear that directors have some duty in carrying out the statutory mandated duty of supervision in their role of directing the management of the corporation. They must take steps to see that the officers of the corporation are properly managing its business and affairs. Since directors must be able to delegate functions except for those which are non-delegable by statute or otherwise, they are protected by the business

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53 DGCL section 141 (c)  
54 257 A.2d 234 (Del. Ch. 1969)  
55 31 Del. Ch. 227, 68 A.2d 817 (Del. Ch. 1949)  
56 2 W. Fletcher, Cyclopedia of the Law of Private Corporations sections 494-495 (rev. perm. ed. 1982)  
57 Unocal vs. Mesa Petroleum Co., 463 A.2d. 946, 953-54 (Del 1985)  
judgment rule if they consciously decide to delegate development and supervision of a particular matter to reliable officers or other subordinates or to outside experts. If such a decision to delegate is made consistently with all the elements of the business judgment rule, the directors are protected from liability. As the Delaware Supreme Court stated in *Rosenblatt vs. Getty Oil Co.*:

An informed decision to delegate a task is as much an exercise of business judgment as any other. The realities of modern corporate life are such that directors cannot be expected to manage the day-to-day activities of a company. This is recognized by the provisions of Delaware General Corporations Law section 141 (a) that the business and affairs of a Delaware corporation are managed ‘by or under the direction’ of its board. In setting its agenda as to the matters in which it will be directly involved, and those it will delegate, a board’s decisions in those matters are entitled to equal consideration as exercises of business judgment.

On the other hand, the court noted in *Aronson* that the business judgment rule “has no role where the directors have either abdicated their functions or absent a conscious decision, failed to act.” When the directors delegate to the officers or other agents, the extent to which the directors must monitor or oversee the work of their subordinates is critical.

While the corporation may be liable for acts of the officers and other agents, it does not follow that directors are personally to the corporation in a shareholder derivative suit or


60 Rosenblatt vs. Getty Oil Co. 493 A.2d 929, 943 (Del. 1985)

61 Aronson vs. Lewis, 473 A.2d 805,813 (Del. 1984)
damage to the corporation caused by acts of its officers or other agents. In *Graham vs. Allis Chalmers Manufacturing Co.*, the Supreme Court of Delaware held that directors are not liable to “ferret-out” the lapses of the officers unless the directors have been warned or unless the “red flags” are obvious. The *Graham* court held that “absent cause for suspicion there is no duty upon the directors to install and operate a corporate system of espionage to ferret out wrongdoing…”

So what is the standard of care in the oversight context? *Aronson* and *Trans Union* hold that the Delaware standard is gross negligence in the informed basis/due care decision making context. In *Lutz vs. Boas* the court found that non-affiliate directors of a mutual fund were liable for “abdicating their responsibilities” and that they were “grossly negligent” in the application of “even an average attention to duty… would have revealed” the improper conduct of the fund’s advisers. Therefore the established standard for Delaware in the oversight context is also gross negligence.

That was the standard then. In the latter part of this paper, we shall delve into the Post Enron decisions cases on point to see if at all the standards have evolved.

**B.) DELAWARE’S DUTY OF LOYALTY AND INTERESTED DIRECTOR TRANSACTIONS**

A duty of loyalty is owed by a director to the corporation and this duty is a companion obligation to the duty of care. These duties are based upon the fact that the directors are ultimately duty-bound to the shareholders. Thus the directors are charged with a duty of

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62 Allison vs. General Motors Corp., 607 F. Supp. 1106, 1114  
63 41 Del.Ch. 78, 188 A.2d 125 (Del. 1963)  
64 Id. at 85, 188 A. 2d. at 129  
65 39 Del. Ch. 585, 171 A. 2d 381 (Del. Ch. 1961)  
66 Id. at 610  
67 ABA Corporate laws committee, Corporate Directors Guidebook, 33 Bus. Law. 1591
loyalty to the corporation to fulfill shareholder primacy. It can therefore be said, that the duty of loyalty mandates that the director refrain from self dealing. Breach of loyalty involves board approval of transactions to enhance personal financial gain of one or more directors who participate in the board approval. When a director votes on a transaction involving such personal gain he is an “interested director”. At common law, interested director transactions were voidable whether or not they were fair or approved by disinterested directors. Later, the law evolved, in that these transactions are not voidable if such a holding would be inequitable or inappropriate under the circumstances so that fair transactions approved by a majority of disinterested directors could be sustained. Delaware adopted a safe harbor statute which governs interested director transactions. Approval or ratification by fully informed, disinterested directors or shareholders is sufficient under Delaware law to invoke the business judgment doctrine. The Delaware statute DGCL in section 144 (a) provides

(a) No contract or transaction between a corporation and one or more of its directors or officers, or between a corporation, partnership, association or other organization in which one or more of its directors, are directors or officers, or have a financial interest, shall be void or avoidable solely for this reason, or solely because the director or officer is present at or participates in the meeting of the board or committee which authorizes the contract or transaction or solely because it is or their votes are counted for such purpose, if:

(1) the material facts as to his relationship or interest and as to the contract or

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68 Ruder, Duty of Loyalty – A Law Professor’s status report, 40 Bus. Law. 1383 at 1386
69 Cheff vs. Mathes, 41 Del. Ch. 494. 199 A.2d 548 (Del. 1964)
70 Marsh, Are Director’s Trustees? Conflict of interest and Corporate morality 22 Bus. Law. 35
transaction are disclosed or are known to the board of directors or the committee, and the board or committee in good faith authorizes the contract or transaction by the affirmative votes of a majority of the disinterested directors even though the disinterested directors be less than quorum; or

(2) the material facts as to his relationship or interest and as to the contract or transaction are disclosed or are known to the shareholders entitled to vote thereon, and the contract or transaction is specifically approved in good faith by vote of the shareholders; or

(3) the contract or transaction is fair as to the corporation as of the time it is authorized, approved or ratified, by the board of directors, a committee or the shareholders.\textsuperscript{71}

Delaware Statute requires entire fairness in interested director transactions and the entire fairness requires a showing of fair dealing as well as fair price. \textit{Weinberger vs. U.O.P Inc}\textsuperscript{72} states the general law as follows;

The concept of fairness has two basic aspects: fair dealing and fair price. The former embraces questions of when the transaction was timed, how it was initiated, structured, negotiated disclosed to directors, and how the approvals of the directors and the stockholders were obtained. The latter aspect of fairness relates to the economic and financial considerations of the proposed merger, including all the relevant factors … However the test for fairness is not a bifurcated one as between fair dealing and fair price. All aspects of the issue must be examined as a whole since the question is one of entire fairness. However, in a

\textsuperscript{71} Delaware General corporations Act DGCL, section 144 (a); section 8.31 Revised Model Business Corporations Act (RMBCA) is fundamentally similar to the DGCL.

\textsuperscript{72} 457 A.2d 701 (Del. 1983)
non fraudulent transaction, we recognize that price may be the preponderant
consideration outweighing other features of the merger. Here, we address the two
basic aspects of fairness separately because we find reversible error as to both.\footnote{Id. at 711}

The principal pre- Enron Delaware case deciding the circumstances under which the
business judgment rule or the entire fairness test is applicable in interested director
transaction is the chancery decision in \textit{Puma vs. Marriott}\footnote{283 A. 2d 693 (Del Ch. 1971)} The Marriot corporation
bought the stock of entities controlled by the Marriott family which owned 44 per cent of
the corporation’s stock and held four of the nine seats on the board. The methodology
used by the disinterested directors persuaded the court not only of their independence but
also their care in using economic data and expert advice in arriving at what they believed
to be fair terms. Ultimately the court held that the business judgment rule applied and it
would not make its own determination of fairness:

Plaintiff here has utterly failed to make any showing of dominion of the outside
directors. No attempt was made to impugn the integrity or good faith of these
directors, all whom were men of experience in the business financial world. There
is no testimony which even tends to show that the terms of the transaction were
dictated by Marriot Group or any member thereof. On the contrary, the valuations
of the property companies and the Marriott stock were made by a majority of
directors whose independence is unchallenged, based upon appraisal, analysis,
information opinions provided by independent experts, whose qualifications are
not questioned. In this circumstances it cannot be said that the Marriot Group

\footnote{Id. at 711}
\footnote{283 A. 2d 693 (Del Ch. 1971)}
stood “on both sides of the transaction” within the meaning of the rule followed in
the cases above cited. Therefore, the test here applicable is that of business
judgment there being no showing of fraud.\(^{75}\)

In certain Delaware cases involving interested director, transactions, the board of
directors has presented the transactions to the shareholders for ratification and
approval.\(^{76}\) Whereas in \textit{Fliegler vs. Lawrence}\(^{77}\) the supreme court of Delaware
determined that because the defendant directors stood on both sides of the transaction, the
burden was upon them to demonstrate its “intrinsic fairness.” The import of the \textit{Fliegler}
decision is that in the situation where the “interested directors” constitute a controlling
shareholder constituency, Section 144(a)(2)\{share holder ratification\} cannot be relied
upon to shield such a transaction from judicial review.\(^{78}\) \textit{Fliegler} involved an option
agreement granting to corporation A rights to acquire corporation B which was owned
by directors of corporation A. Corporation B was formed to develop potentially valuable
property which A could not acquire. The option agreement was exercised by A’s board
and approved by the shareholders. The issue was that the interested (controlling) directors
( in their role as shareholders) had participated in the shareholder vote approving the
transaction. Only one-third of the votes had been cast by disinterested shareholders. The
court in \textit{Fliegler} stated that section 144 was not intended to override the traditional
principles set forth in such cases as \textit{Gottlieb vs. Heyden Chemical Corporation}\(^{79}\) that if
disinterested shareholders ratify an interested director’s transaction “the entire
atmosphere is freshened” so that the burden shifts to the challenger of the transaction to

\(^{75}\) Id. at 695
\(^{76}\) Gottlieb vs. Heyden Chem.Corp. 33 Del. Ch. 177, 91 A.2d 57 (Del. 1952)
\(^{77}\) 361 A.2d 218 (Del.1976).
\(^{78}\) Id. at 222
\(^{79}\) 33 Del. Ch. 177, 91 A.2d.57 fn.75 supra (Del. 1952)
prove gift or waste. Therefore this court’s holding was that a shareholder vote on an interested director’s transaction must be a vote of disinterested shareholders.

i.) Corporate Opportunities and Competition with the corporation

The general rule is that a director, officer or controlling shareholder may not appropriate an opportunity rightfully belonging to the corporation. The initial inquiry is therefore whether the opportunity was one that belonged to the Corporation. The courts have used different tests or combinations of tests to resolve such questions. To determine whether a corporate opportunity is involved, the Delaware case law has indicated that it must fall either within the line of business of the corporation or it is one in which the corporation has an interest. What activities are included in the corporation’s line of business? These have been defined as “any activity as to which (the corporation) has fundamental knowledge, practical experience and the ability to pursue,… and (which is) consonant with its reasonable need and aspirations for expansion…” If the opportunity is closely tied to the corporation’s business, a director taking such opportunity for himself may find himself liable for his actions. Later in this article we shall examine the Post-Enron court case interpretations of this concept.

Whether the opportunity came to the fiduciary in his “individual capacity” or his “corporate capacity” is yet another issue of determination. If the opportunity is received in the fiduciaries individual capacity, there is some authority that he is not required to

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80 Guth vs. Loft, Inc, 23 Del. Ch. 255, 5 A.2d 503 (Del. 1939)
81 For example: (a) “line of business” test Guth vs. Loft id. fn 79; (b) the “corporate expectancy” test, Morad vs. Coupounas, 361 So. 2d 6 (Ala. 1978); (c) the “fairness test”, Weiss vs. Kay Jewelry Stores, Inc. 470 F. 2d 1259 (D.C. Cir. 1972)
82 Equity Corp vs. Milton, 43 Del. Ch. 160, 221 A.2d 494 (Del. 1966)
83 Guth vs. Loft, Inc, 23 Del.Ch. 255, 279, 5 A. 2d 503, 514
84 In re Ebay Inc shareholders litigation, consolidated C.A. No. 199988-NC: In re Oracle Corp Derivative Litigation, 824 A.2d 917 (Del. Ch.)
offer it to the corporation, but if the corporation has an interest in the opportunity or
corporate or corporate resources are used, it must be offered to the corporation.\textsuperscript{85}

Inherent in a director’s duty of loyalty to the corporation is a requirement against
entering into a business in direct competition with the corporation to which the duty is
owed. If the fiduciary’s competing business causes injury to or has a substantial
detrimental effect on the primary corporation, the fiduciary has breached his duty of
loyalty.\textsuperscript{86}

\textbf{ii.) Procedural Protections limiting director liability:}

Delaware courts have reinforced the substantive limitations on director liability with
procedural barriers to plaintiff’s claims against directors. In particular, the demand
requirement and the special litigation committee device frequently functioned to allow
directors to dismiss derivative litigation on procedural grounds and thus avoid litigating
the substantive merits of the shareholders claims.\textsuperscript{87}

\textbf{a.) Demand requirement}

Under the demand requirement, a shareholder may not bring a derivative action without
first making a demand on the corporation’s directors to bring the suit directly unless
asking such a demand would be futile.\textsuperscript{88} The purpose of the demand is to give a
corporation the opportunity to rectify an alleged wrong without litigation and to control
any litigation which does arise.\textsuperscript{89} If a demand is not made before the suit is filed, the
plaintiff bears the burden of alleging with particularity in the complaint the reasons why

\textsuperscript{85} Id. fn 82 supra.
\textsuperscript{86} Williams vs. Stirling, 583 P.2d 290
\textsuperscript{87} James D. Cox & Thomas Lee Hazen, Corporations at 429 (2d ed. 2003)
\textsuperscript{88} Del. Ch. Ct. rule 23.1
\textsuperscript{89} Aronson vs. Lewis, 473 A.2d 805, 809 (Del, 1984)
demand would have been futile.\textsuperscript{90} If a derivative plaintiff fails to carry his burden of alleging the particularity facts sufficient to excuse demand, his complaint must be dismissed even if his claim is otherwise meritorious.\textsuperscript{91} In \textit{Aronson} the Delaware Supreme court set forth the following standard two prong test for determining whether demand should be futile and is therefore excused under which the Court of Chancery must determine whether “under the particularized facts alleged, a reasonable doubt is created that the directors are disinterested and independent, or that the challenged transaction was otherwise the product of a valid exercise of business judgment”\textsuperscript{92} If the demand satisfies either condition the demand is excused and the case may proceed.

\textbf{b.) Special litigation committees}

If demand is deemed excused, the board may nonetheless appoint a committee of independent directors to determine whether the litigation is in the corporation’s best interests, and if appropriate, to seek a dismissal.\textsuperscript{93} In this situation the directors would have an additional opportunity to avoid litigating the shareholders case on the merits. The Court of Chancery decision in \textit{In re Walt Disney Co. Derivative litigation (Disney 1)}\textsuperscript{94} demonstrates the power of these procedural mechanisms to frustrate plaintiffs meritorious claims. In this case, Disney hired Michael Ovitz, a close friend of CEO Michael Eisner, as its President and Chief operating officer. By all accounts, Ovitz’s tenure at Disney was a total failure. Within twelve months, Ovitz was seeking other employment. With Eisner’s help, Ovitz negotiated a soft landing, departing Disney after fourteen months with a severance package worth $140 million. Disney shareholders

\textsuperscript{90} Id at 815
\textsuperscript{91} Colonial Securities Corp vs. Allen, C.A. No. 6778 (Del. Ch.1983)
\textsuperscript{92} Aronson vs. Lewis fn. 88 at 814
\textsuperscript{93} Zapata vs. Maldonado, 430 A.2d at 785-89
\textsuperscript{94} 731 A.2d 342 (Del. Ch. 1998)
brought a derivative action against Disney’s directors and former directors. They alleged breaches of the fiduciary duties of care and loyalty both for initially approving Ovitz’s employment contract and for subsequently approving Disney’s non-fault termination of Ovitz which entitled him to receive such exorbitant benefits. 95

The Disney defendants moved to dismiss the complaint for failure to make a demand. Despite the meritorious facts alleged in the case, the court displayed a skeptical attitude to the Plaintiffs case.96 According to the court, the sheer dollar amount of the severance and the unusual circumstances under which it was granted did not mean that conventional corporate governance rules would not apply in evaluating the boards decision.97 Instead, the court resolved to analyze the plaintiffs claim “using the same tools it uses in any corporate law case, namely the requirements of demand or its excusal, the Aronson vs. Lewis test, the basic rules of disclosure and most significantly, the business judgment rule.”98 Central to the plaintiff’s claim of demand futility was that Eisner had an impermissible interest in Ovitz’s employment contract, due to his close relationship with Ovitz. Eisner allegedly used his domination over the board to force them to approve Ovitz’s ill-advised contract. The plaintiffs also argued that Eisner relied on his domination of the board to goad them to approve Ovitz’s “non-fault termination” and the lucrative severance benefits granted there under.

The court gave little credence to these arguments.99 Stating that “a board member is

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95 Renee M. Jones: Rethinking Corporate federalism in the Era of Corporate reform, Corporate practice commentator at 70
96 731 A.2d 342 fn. 93 at 350
97 Id.
98 Id. at 350-51
99 Id. at 355
considered to be disinterested when he or she neither stands to benefit financially from nor suffer materially form the decision whether to pursue the claim sought in the derivative plaintiff’s demand.\footnote{Id. at 354} the court limited its inquiry into Eisner’s independence, into any financial benefit to Eisner from the Ovitz agreement or the subsequent non-fault termination.\footnote{Id. at 355-56} Finding that plaintiffs had not credibly alleged such financial interest, the court held Eisner’s independence beyond reproach.\footnote{Id. at 356} In so holding the court minimized the relevance of Eisner’s relationship with Ovitz stating that “demand is not excused… just because directors would have to sue ‘their friends, family and business associates.’”\footnote{Id. at 355}

The Court also evaluated plaintiff’s claims that Eisner dominated the board of Directors. Despite extensive personal and professional ties among Eisner and most of the other Disney directors, the court found that at least nine of twelve board members were independent of Eisner. Not only did the court deem several Disney executives, former executives and consultants independent of Eisner\footnote{Id at 356-60} it also found independent individuals with more personal connections to Eisner. For instance, father Leo J. O’Donovan was president of Georgetown University which Eisner’s son had attended and to which Eisner personally had contributed more than $1 million.\footnote{Id at 359} Another director, Reveta Bowers, was the principal of the elementary school that Eisner’s children once attended.\footnote{Id.} The court ruled that neither these personal connections to Eisner, nor the relative significance of the directors fees paid to this individuals created doubt as to their ability to act
independently of Eisner. Ultimately the court concluded that because of the plaintiff’s failure to raise reasonable doubt of the independence of a majority of the directors, plaintiffs had failed to meet the Aronson first prong for demand excusal. The plaintiffs fared no better under Aronson’s second prong, which required that the facts alleged raise a reasonable doubt that the “challenged transaction was the product of a valid exercise of business judgment.” The court stated that “the board is not required to be informed of every fact, but rather required to be reasonably informed.” Likewise the court found the plaintiff’s claim of waste deficient because “in the absence of fraud, this court’s deference to the director’s business judgment is particularly broad in matters of executive compensation.” The Disney director’s decision to grant Ovitz a non-fault termination, despite his non-performance and his own initiation of the termination of his employment, was also protected by the business judgment rule.

On appeal, the Delaware Supreme court upheld the dismissal of all the plaintiffs’ claims. Calling the complaint a “pastiche of prolix invective,” the Supreme Court agreed that the plaintiffs had failed to satisfy the demand requirement. This is a classic example of how procedural protections stood in the way of a plaintiff’s otherwise meritorious claim against directors. However the plaintiffs were allowed to amend their pleadings and to re-file their complaint. The plaintiffs indeed refilled and the court’s determination based on the same facts was totally the opposite.

107 Id.
108 Id. at 363
109 Aronson, 473 A.2d at 814
110 731 A.2d at 362
111 Id.
112 Id. at 364
113 Brehm vs. Eisner, 746 A2d. 244 (Del.2000)
114 Id. at 249
115 Id. at 248
116 infra fn.168 at pg.36
C.) DELAWARE’S DUTY OF GOOD FAITH

Although the Delaware courts frequently mention good faith within discussions of the duties of care and loyalty, traditionally the courts have not substantively defined the “duty of good faith.” Further clouding the issue, good faith is not defined in the Delaware General Corporations Law (DGCL). Case law demonstrates the courts’ historical uncertainty as to whether good faith is an independent duty, a component of the duty of care, or a component of the duty of loyalty. Although there has been mention of Delaware’s “triad” of fiduciary duties, good faith has always been an analysis of the duty of loyalty. The Chancery court noted that good faith belongs under a duty of loyalty analysis because “by definition, a director cannot simultaneously act in bad faith and loyally toward the corporation and its stockholders”. This lack of doctrinal clarity prevented good faith from commanding a greater role in stockholder suits.

Despite the uncertainty, Delaware’s Chancery Court’s early formulations of good faith suggested that directors’ conduct that is “reckless and indifferent as to the rights of the stockholders” may break the duty of good faith. Under the traditional duty of care analysis, directors must make a good faith attempt to monitor corporate activity. The monitoring necessary to establish good faith and satisfy fiduciary duty of care was very low. Under Graham vs. Allis-Chalmers Manufacturing Company directors were not required to establish or maintain systems to “ferret out wrongdoing” absent cause for

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117 Zirn vs. VLI Corp. 681 a.2d. 1050,1062 (Del. 1996)
118 Malone vs. Brincat, 722 A.2d 5, 10 (Del. 1998); Cinerama, Inc. vs. Technicolor, Inc. 663 A.2d 1156, 1164 (Del. 1995)
119 Nagy vs. Bistricer, 770 A.2d 43, 49 (Del. 2000)
120 Perrine vs. Penn road Corp., 47 A.2d 479,489 (Del.Ch. 1946)
121 Tara L. Dunn: The developing theory of good faith in Director conduct: Are Delaware courts ready to force Corporate directors to go out-of-pocket after Disney IV ? , Denver University Law Review at 563
122 188A 2d 125, 130 (Del. 1963)
suspicion.\textsuperscript{123} Under \textit{Allis-Chalmers}, unless directors had knowledge of a problem, there was no need to have investigatory systems in place.\textsuperscript{124}\textit{Allis-Chalmers} provided directors with an incentive to take ostrich-like approach to corporate operations, because action was required only if directors had knowledge of suspicious circumstances.\textsuperscript{125} Later in \textit{Re Caremark International Inc. Derivative Litigation} \textsuperscript{126} the Chancery court heightened the monitoring standards by stating that directors must act in good faith in order to discharge their duty of care.\textsuperscript{127} Under \textit{Caremark}, directors have an affirmative obligation to assure that adequate internal systems exist such that the board will receive appropriate information in a timely manner.\textsuperscript{128} Failure to do so, evidenced by a “sustained and systematic failure of the board to exercise oversight” will establish a lack of good faith sufficient to find directors liable for breach of the duty of care.\textsuperscript{129} This served as the first step in defining the Delaware’s duty of good faith. So, come \textit{Re Walt Disney Company Derivative Litigation}, \textsuperscript{130} facts of which are recited \textit{supra}, \textsuperscript{131} although the directors were not found liable for breach of duty of care or for acting in bad faith, this suit provided insights to Delaware’s position on the duty of good faith. The court noted that the “concept of intentional dereliction of duty, a conscious disregard for one’s responsibilities is an appropriate (although not the only) standard for determining whether fiduciaries have acted in good faith. Deliberate indifference and inaction in the face of a duty to act …is conduct that is clearly disloyal to the corporation. It is the

\textsuperscript{123} Allis Chalmers, 188 A.2d at 130
\textsuperscript{124} Id.
\textsuperscript{125} Id.
\textsuperscript{126} 698A.2d 959
\textsuperscript{127} Caremark, 698 A.2d at 968
\textsuperscript{128} Id. at 969-70.
\textsuperscript{129} Id. at 971
\textsuperscript{130} Consolidated C.A. No. 15452, 2005 WL 1875804 (Del. Ch. Aug. 2005)
\textsuperscript{131} \textit{supra} at pg. 26
epitome of faithless conduct. To act in good faith, a director must act at all times with honesty of purpose and in the best interests and welfare of the corporation.” Failure to act in good faith includes affirmative acts such as “acting with the intent to ‘violate applicable positive law (such as the Sarbanes-Oxley Act or SRO rules).”

Good faith has been inferred as a prerequisite of the business judgment rule and to several vitally important statutory protections for Directors under DGCL. Of utmost importance is the exculpatory charter provision of Section 102(b) (7) of the DGCL. Under section 102 (b) (7), stock holders may adopt an exculpatory charter provision in their certificate of incorporation protecting directors against personal liability for breaches of fiduciary duties. Claims alleging only a breach of the duty of care are barred by section 102(b) (7). Delaware courts have been unwilling to infer bad faith into claims premised solely on the duty of care.

According to the Supreme Court, it is not enough to argue that the duty of care claims are “inextricably intertwined with loyalty and bad faith claims” in the face of a section 102(b) (7) charter provision. In cases of interested director or officer transactions, under DGCL section 144(a), a majority of the disinterested directors can approve the transaction and prevent it from being voidable as long as they are fully informed and act in good faith.

And under DGCL section 141(e), directors are fully protected in relying on the

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132 Disney, fn 128 at 123-24
133 Id. at *36
134 Del. CODE ANN. Tit 8 section 102(b) (7), 141, 144, 145 (2005) ; See also E. Norman Veasey State – federal tension in corporate governance and the professional responsibilities advisors. 28 J. Corp. L. 441,443,447 (2003) (noting that the duty of good faith arises under case law and under DEL CODE ANN. tit. 8 section 102(b) (7) and DEL. CODE ANN. Tit. 8 section 145).
135 DEL CODE ANN tit.8 section 102(b)(7) (2005)
136 Malpiede vs. Towson 780 A.2d 1075,1095 (Del.2001) (Citing Emerald partners vs. Berlin, 726 A.2d. 1215,1224 (Del. 1999)
137 See Malpiede, 780 A.2d at 1093-94
138 Id. at 1093
139 DEL.CODE ANN.tit 8 section 145 (2005)
corporation’s officers, committees of the board, or experts if such reliance is made in good faith.\textsuperscript{140} To succeed on this section the directors must reasonably rely on the expert opinion.\textsuperscript{141} In short, meeting the obligation to act in good faith is crucial for directors to enjoy Delaware’s procedural and statutory protections and avoid potential personal liability under state law. First, a failure to act in good faith will allow a plaintiff to overcome the presumption of the business judgment rule and establish demand futility under the second prong of \textit{Aronson}. Second a failure to act in good faith will prevent directors from utilizing several statutory protections. Directors who fail to act in good faith in reliance of corporate records, executives committees of the board or experts will not be protected in their actions under DGCL section 141(e).\textsuperscript{142} Approved interested – director transactions not made in good faith will also be unprotected under DGCL section 144 (a)\textsuperscript{143}. Further failing to act in good faith will prevent statutory indemnification under DGCL section 145.\textsuperscript{144} Even more importantly, a failure to act in good faith is not exculpable under DGCL section 102(b)(7).\textsuperscript{145}

The best and most current articulation of Delaware’s Good faith theory was in the \textit{Disney IV} decision of August, 2005. Unless another similar matter, based on the same theory comes up, this case remains the most current guidance on the elements of Delaware’s fiduciary duty of good faith, which can be said \textit{arguendo} has come full circle.

\textbf{3.) SARBANES OXLEY 2002: DELAWARE’S RESPONSE TO SARBANES-OXLEY}

Examining the \textit{Sarbanes-Oxley}\textsuperscript{146} Acts impact on the development of state corporate law

\begin{footnotesize}
\begin{enumerate}
  \item DEL.CODE ANN tit 8 section 141 (e) (2005)
  \item Id.
  \item DEL.CODE ANN tit. 8, section 141 (e) (2005)
  \item DEL. CODE ANN tit 8, section 144 (a) (2001)
  \item Id. at section 145 (2001)
  \item Id. at section 102(b)(7) (2001)
  \item Sarbanes- Oxley Act ,2002
\end{enumerate}
\end{footnotesize}
offers an opportunity to evaluate whether the threat of federal preemption actually works the way corporate federalists predicted. The corporate scandals involving Enron, WorldCom, Adelphia and others evoked broad public dissatisfaction with the existing corporate regulatory regime. As a result, Congress and other federal regulators were compelled to address the perceived problems. This popular pressure for more extensive corporate regulation was significant, as it empowered Congress to encroach significantly on traditional state law terrain. Eventually, Congress approved the enactment of the Sarbanes-Oxley Act of 2002 in to law. Sarbanes-Oxley represents an amalgamation of reform proposals since the Enron debacle first came to light. The Act reformed regulation of the accounting industry, enhanced securities law disclosure requirements, created a number of new white collar crimes, and enhanced criminal and civil penalties for corporate fraud.

It is not only the Sarbanes Oxley that has changed things for Directors corporate control. We have the New York Stock Exchange rules, NASDAQ rules, and recommendations from various private organizations that set the standard for a state of the art. The private organizations are the conference Board, the business round table, the Higgs report in the United Kingdom and the American Bar Association reports.

150 Sarbanes-Oxley Act section 101-08
151 Id. section, 302, 401-09
152 Id. section, 802, 906, 1102-07
153 Id. section, 305, 804, 1105
155 Restoring trust in America’s Business Institutions; by Margaret M. Blair & William W. Bratton Sloan project on Business institutions at the Georgetown law centre, conference proceedings pg. 62
There is a great deal of convergence by the various groups and the Securities Exchange Commission, SEC in their rules passed under the Sarbanes Oxley as to the expectations respecting Directors in the Post Enron era.

The expectations are that directors have to be more informed, more active and more independent than they have been in the past. The Board of Directors is also required by the Sarbanes Oxley to monitor the officers, the CEO and the CFO’s evaluations of the overall correctness and accuracy of the internal controls and the disclosure controls. In other words, they too must be informed and for purposes of litigation, it will be inferred that they had notice as to the business and finances of the company.

Sarbanes Oxley requires review and monitoring of the company’s systems of disclosure, controls and procedures and of internal financial monitoring or non-financial disclosures. The company has to set up an entire system in great detail documenting that it has the information that’s necessary for disclosure flow from the lower echelons to the chief executive officer and to the chief financial officer who have to certify the accuracy of their disclosure under civil and criminal penalties. Directors have also to assess the adequacy and efficacy of the disclosure controls that are set in place. The overriding rule that the SEC and the accounting profession have had for years has been fair presentation. The current climate is defined by developments that force the directors to confront heightened scrutiny of their actions, including the very real possibility of personal liability, high profile corporate cases against directors and officers and increasingly

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156 Id. at pg. 63  
157 Id. at pg.63  
158 Joann S. Lublin et al., Directors are getting the Jitters: Recent settlements Tapping Executive Personal Assets put Boardrooms on edge, WALL ST.J., 13 2005, at B1 (Recent out of pocket settlements by Directors): Executives on trial: Guilty, Not Guilty, Mistrial, WALL ST.J., ONLINE, July 13, 2005, at B1
sophisticated institutional investor plaintiffs with their recent efforts to make directors pay settlements out-of-pocket.\footnote{159}{Michael Klausner et al., \textit{Outside Directors’ Liability: Have WorldCom and Enron changed the rules?} 71 STAN. L.AW. 36 (Winter 2005), available at \url{http://www.law.stanford.edu/publications/lawyer/issues/71/klausner.html} (discussing the recent push by plaintiffs to force directors to pay portions of settlements out-of-pocket even when there is directors and officers insurance available).}

Appointment of the Audit committee is now a requirement by law.\footnote{160}{Sarbanes-Oxley Act, section 301.} It specifies that the audit committee must retain responsibility for appointing, compensating, and overseeing the work of the company’s independent auditor and that the auditors must report directly to the committee.\footnote{161}{Id.} The Act also demands that the audit committee have the authority to hire independent advisers, such as lawyers and accountants and that companies must provide the committee with the necessary funding to fulfill its newly-designed duties.\footnote{162}{Id. section 301}

Finally, the Act requires the audit committee to establish a reporting system for receipt of confidential, anonymous reports from employees (whistle blowers) concerning questionable accounting or auditing matters.\footnote{163}{Id.} The committee must be composed completely of independent directors.\footnote{164}{Id.} The Act’s definition of independence is more stringent than that embodied in Delaware common law. To qualify as independent under the Act, a director cannot accept payment of any consulting, advisory, or other compensatory fees other than director fees.

The New York stock exchange has issued new governance standards requiring that the audit committee regularly reports to the full board all accounting problems and all accounting issues of which they become aware. The Sarbanes Oxley made it clear that the audit committee is going to be the source of good and negative information flowing to

\begin{footnotesize}
\begin{enumerate}
\item[159] Michael Klausner et al., \textit{Outside Directors’ Liability: Have WorldCom and Enron changed the rules?} 71 STAN. L.AW. 36 (Winter 2005), available at \url{http://www.law.stanford.edu/publications/lawyer/issues/71/klausner.html} (discussing the recent push by plaintiffs to force directors to pay portions of settlements out-of-pocket even when there is directors and officers insurance available).
\item[160] Sarbanes-Oxley Act, section 301.
\item[161] Id.
\item[162] Id.
\item[163] Id.
\item[164] Id. section 301
\end{enumerate}
\end{footnotesize}
the Board, starting with the whistle blower. Accounting whistle blower complaints must be handled by the audit committee. This is true of Delaware’s duty of disclosure which requires that independent directors who are members of the audit committee have a duty to disclose all information gained as members of the committee to the board.

**Select Court Decisions Pointing At Delaware’s Response:**

**Post Enron**

Writing in early 2002, Delaware Vice-Chancellor Leo Strine predicted that “the Enron debate will create pressure on the current standards of corporation law, and… participants in the policy making process will identify what they perceived as inadequacies in that law, which they will cite as justifying a stronger role for federal regulation.”

Norman Veasey, Chief Justice of the Delaware Supreme Court bluntly stated “if we do not fix it, congress will, but I hope they’ve gone as far as they’re going to have to go.” Recent Delaware Supreme court decisions suggest a stricter judicial scrutiny of director decision making. Since June of 2002, the Delaware Supreme court has reversed chancery courts decisions in favor of defendant directors, and ruled for the shareholder-plaintiffs several times. Moreover, the Supreme Court’s jurisprudential shift has trickled down to the court of chancery, which apparently has taken heed of the supreme court’s message after the numerous reversals. The following analysis of Post Enron decisions seek to analyze Delaware’s judicial shift although it is impossible to...
conclusively identify the causes of the purported shift because it could simply be a part of a natural norm evolution that characterizes common law.

i) The Duty of Care & Duty of Good Faith: Post - Enron

In *Re Walt Disney Co. Derivative Litigation*\(^{169}\) (hereinafter referred to as *Disney 2*) the court re-examined the two stalwart defenses of Duty of care claims: Business judgment rule and exculpation. In this decision Chancellor Chandler, revisited claims of the plaintiffs who had objected to Michael Ovitz’s generous severance package.\(^ {170}\) In the Pre-Enron era, Chancellor Chandler had dismissed all of the plaintiff’s claims.\(^ {171}\) In *Disney 2* he concluded that the board’s alleged conduct may have constituted such gross negligence as to violate Delaware’s “good faith” requirements, thereby denying defendants exculpatory protections. In *Disney 2* the plaintiffs amended the plaint alleging that the directors failed to exercise any business judgment. Broadly speaking the complaint contained the same fact pattern as the complaint presented in *Disney 1*.\(^ {172}\) This time Chancellor Chandler concluded that the allegations had created a doubt that the challenged transactions were entitled to business judgment rule protection.\(^ {173}\) In *Disney 1*, The Chancellor adopted a deferential approach to evaluating board conduct. He dismissed as insignificant the boards alleged failure to quantify the value of Ovitz’s termination payout, stating that “aboard is not required to be informed of every fact, but rather is required to be reasonably informed.”\(^ {174}\) In a remarkable reversal, in *Disney 2*, he found the plaintiff’s allegations quite troubling:

\(^{169}\) 825 A.2d 275 (Del. Ch. 2003)

\(^{170}\) Id. at 356

\(^{171}\) The Supreme Court upheld the chancellor’s ruling, but reversed the “with prejudice” aspect of the dismissal of the plaintiffs’ claims that the boards processes were not entitled to the business judgment rule protection. Brehm, 746 A.2d at 248

\(^{172}\) See *Disney 1*, supra fn. 93

\(^{173}\) *Disney 2*, 825 A.2d at 288-89

\(^{174}\) *Disney 1*, 731 A.2d at 362
These facts, if true, do more than portray directors who, in a negligent manner, merely failed to inform themselves or to deliberate adequately about an issue of material importance to their corporation. Instead, the facts alleged in the new complaint suggest that the defendant directors consciously and intentionally disregarded their responsibilities, adopting a “we don’t care about the risks” attitude concerning a material corporate decision.\(^\text{175}\)

In conclusion, there was a significant change of legal opinion in the holding of Disney 2 Post-Enron.

ii.) Duty of Loyalty: Post-Enron

Delaware’s recent jurisprudence also makes it more difficult for defendants to dispose of duty of loyalty claims. In particular, the strict fairness test has been applied more broadly to a range of contexts including corporate opportunity and conflicts caused by director disinterestedness. Courts have in the same breathe undercut the protective value of independent committee approval for conflict of interest transactions. A few decisions to illustrate are in order.

(a) In Re EBay, Inc. Shareholders Litigation

In the recent 2004 decision of Re eBay, Inc Shareholders litigation,\(^\text{176}\) the court adopted a more stringent test for director independence. The EBay court considered allegations by the shareholders that directors and officers had breached their duty of loyalty by usurping corporate opportunities. It was alleged that the defendant investment bank had offered the directors and officers lucrative initial public offering shares in appreciation for past business and to obtain future business. The facts as pleaded are that in 1995, the

\(^{175}\) 825 A.2d at 289
\(^{176}\) Consolidated C.A. No. 19988-NC
defendants Pierre M. Omidyar and Jeffrey Skoll founders of eBay, retained Goldman Sachs as their lead underwriter in their initial public offering of common stock. Due to the huge success of the IPO, Goldman Sach’s was asked to serve as eBay’s financial advisor in connection with an acquisition by eBay of PayPal, Inc. For both this services, eBay paid Goldman Sach’s handsomely.

During the same time Goldman Sachs “rewarded” the individual defendants by allocating to them thousands of IPO shares, managed by Goldman Sachs, at the initial offering price. Because the IPO market at this time was extremely active, prices of initial stock offerings often doubled or tripled in a single day. Investors who were well connected either to Goldman Sachs or other investment underwriters were able to flip these investments into instant profit by selling the equities in a few days or even in a few hours after they were initially purchased.

The allegation is therefore that Goldman Sachs provided these IPO allocations to the individual defendants to show appreciation for eBay’s business and to enhance Goldman Sachs’ chances of obtaining future eBay business

Chancellor Chandler determined that investing in short term securities was “a line of Business” of EBay. He agreed with the plaintiffs that going by the 1999 form 10K for instance, EBay “consistently invested a portion of its cash on hand in marketable securities….” Because the facts point that investing was an integral part of EBay’s management strategy, and EBay was never given an opportunity to turn down the IPO allocations, the Directors and officers were in breach of their duty of loyalty to the corporation as “an agent is under a duty to account for profits obtained personally in

177 Gibralt Capital Corp vs. Smith, 2001 WL 647837 at*9 (Del Ch. 2001)
connection with transactions related to his or her company… Thus even if one does not consider Goldman Sachs’ IPO allocations to these corporate insiders… allocations that generated millions of dollars in profit… to be a corporate opportunity the defendant directors were nevertheless not free to accept this consideration form a company, Goldman Sachs, that was doing significant business with EBay and which arguably intended the consideration as and inducement to maintaining the business relationship in the future.\(^\text{178}\)

(b) In \textit{Re Oracle Corp Derivative Litigation}

The plaintiff shareholders in \textit{Re Oracle Corp Derivative Litigation}\(^\text{179}\) brought an action against the defendant corporation directors on allegations of insider trading while in possession of material non-public information. The Special litigation committee moved to dismiss the action. This suit centers around four members of Oracle’s board of directors: Lawrence Ellison, who is Oracle’s chairman, CEO, and its largest stockholder. By virtue of his managerial position he has access to inside information on a regular basis. Jeffrey Henley, its CFO and director of the corporation. Donald Lucas is a director who chairs Oracle’s Executive committee and its finance and audit committee. Michael Boskin is a director and chairman of the compensation committee and a member of the Finance and Audit committee Because of their insider positions they possessed material non-public information demonstrating that Oracle would fail to meet the earnings and revenue projections for that year. Armed with this information, the directors disposed of their shares, while continuing to assure the market that Oracle would meet its financial objectives. When the information was made public, Oracle’s share price plummeted to

\(^\text{178}\)\textit{Restatement (second) agency} 388 (1957)

\(^\text{179}\) 824 A.2d 917 (Del. Ch. 2003)
an all time low. The plaintiffs allege that the defendants breached their duty of loyalty by misappropriating inside information and using it as a basis for their trading decisions to their own advantage. Oracle formed a special litigation committee to investigate the merits of this derivative action composed largely of friends of the directors with whom they held close ties. For example, Hector Garcia Molina and Joseph Grundfest are both Professors at the Stanford University and institution that befitted from Donald Lucas’ donations of up to $50,000 worth of stock, the Special Litigation Committee’s appointed counsel had previously performed work for Oracle and other board members on a personal level. The Special litigation committee members did not draw any fees from the corporation for heir services. After conducting an investigation the Special litigation committee moved to terminate the litigation.

The courts conclusion was that the Special litigation committee membership was not free from bias and that it failed to meet its Zapata\textsuperscript{180} test and its motion to terminate must be denied because its good faith and reasonableness of its conclusions would not be sufficient to justify termination.

The lesson learned is, that approval by facially independent directors no longer suffices to shield conflict of interest transactions from judicial scrutiny. Actual independence measured in deeds rather than financial interests, appears to be the new standard.\textsuperscript{181}

4. CONCLUSION:

Although there appears to be an increase in shareholder cases based on breach of fiduciary duty claims in the wake of Enron, and Sarbanes Oxley, the Delaware courts have repeatedly declined the invitation of Shareholder plaintiffs to broadly expand

\textsuperscript{180} Zapata vs. Maldonado 430 A.2d. 779
\textsuperscript{181} Texlon Corp.vs Meyerson 802 A.2d. 257
Delaware law. Instead the Delaware Judiciary has held fast to well established principles of Delaware law.

These principles have long

Demanded of a corporate officer or director, the most scrupulous observance of his duty, not only affirmatively to protect the interests of the corporation committed to his charge, but also to refrain from doing anything that would work injury to the corporation, or to deprive it of profit or advantage which his skill and ability might properly bring to it, or to enable it to make in the reasonable and lawful exercise of its powers.\textsuperscript{182}

Admittedly, the small number of cases discussed above forms a small sample for making ultimate conclusions about the proper role of federal and state governments in shaping corporate law rules. None the less, a fundamental shift in Delaware corporate jurisprudence does seem to have occurred. But mostly, the shift appears to be toward increased shareholder expectations of Directors’ and officers fiduciary duties, and a pursuit of novel claims against fiduciaries who fall short of those expanding expectations. One could argue therefore that it is the public (i.e. shareholders) that have expanded their expectations of corporate fiduciaries post – Enron and not the Delaware courts.

In summary, allowing states to continue to regulate corporations appears to offer some benefits over a purely federalized scheme. Yet for reasons stated above, because congress can influence state corporate law without preempping it entirely, a practical resolution for corporate reform seems to be closer Congressional scrutiny of corporate regulation, aided by limited preemption when necessary to correct for states’ propensity to place the

\textsuperscript{182} Guth vs. Loft, 5 A. 2d 503, 510 (Del. 1939)
interests of managers above other corporate constituents in crafting corporate law