An Uncertain Trumpet: Delaware Hears the Call of Corporate Governance Reform

*By Daniel Fisher**

Introduction

Delaware, the home of 60% of the Fortune 500,[1] is synonymous with corporate activity and is considered the standard in American corporate law.[2] Delaware statutory and case law also play a large, even dominant, role in governing and influencing corporate behavior and procedures in other jurisdictions.[3] Delaware courts, cognizant of this influence, have generally attempted to fulfill their responsibility by providing stable, measured and reliable corporate laws. However, like all rational actors, Delaware seeks to maintain its leading position as the jurisdiction of choice for incorporation, with all of the benefits that status brings to the state.[4] Thus, Delaware is not immune from a legal form of "market pressure," and its body of law reflects both recent events and developments in federal legislation.

Delaware's reaction to the corporate scandals of recent years sheds light on the state's perception of its role as a standard-setter for corporate behavior and as a leader in maintaining the independence and supremacy of state corporate law. These scandals, and the ensuing federal corporate governance reforms, are perhaps the most severe challenge to the Delaware-led framework of state-made corporate law that has become ingrained in the corporate decision-making process. A recent Delaware case before the Court of Chancery, which addressed the actions of the board of directors of The Walt Disney Company in connection with the hiring and termination of Michael Ovitz as Disney's President, is one of the first attempts by Delaware courts to deal with corporate governance issues in the post-scandal era.[5] *Disney* examines the conduct and oversight of directors, a concern that is at the heart of corporate governance. Initially dismissed in 1998, the case was revived in 2003 in a different corporate governance world. The *Disney* ruling, as well as commentary by leading Delaware jurists and others, indicates that Delaware may be prepared to respond to the corporate law challenges of the 21st century. The link between *Disney* and the commentary—and the most pressing current issue in American corporate law—is the intersection between the heightened duties and responsibilities of a corporation and its directors on the one hand, and the battle for regulatory supremacy between the states and the federal government on the other hand. If Delaware, as the leading state, proves unable to keep up with "progress," the result may be a ceding of power to the federal government and further federalization of American corporate law, especially as federal legislation shifts from a focus on securities regulation to an emphasis on general corporate behavior. This, in turn, would eventually result in little differentiation among the corporate laws of the states, and severely damage Delaware's market position. Thus, Delaware's reactions to recent events and the challenges they bring are of crucial interest to all actors in the corporate law sphere.

***Disney*—Delaware's Response?**

The analysis in *Disney* is built upon the two distinct duties owed by Delaware directors to their corporation: the duty of loyalty and the duty of care.[6] If Delaware directors satisfy these duties, their decisions will be protected by the business judgment rule and, as a practical matter, only in rare occasions will a Delaware court question them.[7] The duty of care requires that directors adequately inform themselves and take proper deliberation in their decision-making process.[8] If directors violate the duty of care, they can be found liable to the corporation.[9] However, in response to cases that found violations of the duty of care and thus director liability, and the ensuing difficulty in directors obtaining D&O insurance, the Delaware legislature amended the Delaware General Corporation Law (DGCL) to include §102(b)(7). Section 102(b)(7) authorizes a Delaware corporation's charter to contain provisions "eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director."[10] However, §102(b)(7) bars the elimination of liability for a breach of the duty of loyalty.[11] Thus, the practical effect of §102(b)(7) is that, when bringing suit against a Delaware company that has a §102(b)(7) charter provision, plaintiffs must generally allege a breach of the duty of loyalty (which includes failing to act in good faith) in order to have a recoverable cause of action.

With this framework in mind, the core question of *Disney*—whether the facts alleged by the plaintiff constitute a violation of the duty of good faith by the directors—reaches the heart of director liability in Delaware. Since Disney's charter contained a §102(b)(7) exculpatory provision, a viable claim alleging breach of the duty of care could not be brought.[12] Thus, the plaintiffs could only be successful in an action that alleged a breach of the duty of loyalty: if the directors did not act in good faith, they could be found liable.[13]

The initial Disney lawsuit was filed in 1998 and alleged a general breach of duty on the part of the directors that was not supported by particularized facts or meaningful discovery.[14] This suit was dismissed by the Court of Chancery. The court stated that under §102(b)(7) and Disney's governing documents, Disney's directors would not be liable for a breach of the duty of care and there was no support on the record for a claim that their directors breached their duty of loyalty.[15] On appeal, the Delaware Supreme Court upheld the Chancery Court's ruling. However, the Supreme Court granted the plaintiffs leave to replead if they could, through discovery, produce facts that would support a valid cause of action.[16] Over the next two years, the plaintiffs used their access to the books and records of Disney[17] to obtain detailed information about the actions of the Disney board in connection with the Ovitz hiring and termination. The plaintiffs then refiled their complaint, and the defendants made a motion to dismiss.

The Disney plaintiffs, represented by Milberg Weiss Bershad Hynes & Lerach LLP, alleged that the Disney directors had breached their duties in connection with the Ovitz hiring and termination. Specifically, the plaintiffs alleged that the directors:

- did not review Ovitz's final employment agreements, but only reviewed term sheets;
- were not aware of changes between the term sheets and the final employment agreements;
- did not receive advice on whether the Ovitz compensation package was consistent with industry practices;
- were not aware of the potential total cost of the Ovitz compensation package, particularity in connection with a possible no-fault termination (which eventually occurred);
- failed to take adequate time to review the terms and content of the Ovitz compensation package, particularly in light of the package's potential cost; and
- left most of the negotiations over the Ovitz compensation package to Disney Chairman and Chief Executive Officer Michael Eisner, who had a long-time personal relationship with Ovitz.

For purposes of the motion to dismiss, the Chancery Court assumed that the facts alleged by the plaintiffs were true. Upon this assumption, Chancellor William B. Chandler III ruled that there was sufficient doubt that the Disney board acted in good faith for the lawsuit to continue, and stated that if "a director consciously ignores his or her duties to the corporation…the director's actions are either 'not in good faith' or 'involve intentional misconduct.'"[18] This ruling can be seen as an expansion of the traditional boundaries of the duty of good faith, and perhaps signals a tightening of Delaware's standards for director conduct. As one of the first major cases to be decided in the post-scandal era, *Disney* could be Delaware's attempt to respond to the corporate scandals and could represent a turning point in its case law.

Others Hear the Call and See the Danger

Disney is not the only evidence of Delaware's reaction to recent corporate and federal legislative events. In a roundtable discussion published by the *Harvard Business Review* in January 2003, Chief Justice E. Norman Veasey of the Delaware Supreme Court made a number of interesting remarks that speak to Delaware's current attitude towards corporate governance.[19] Chief Justice Veasey said that "[d]irectors who are supposed to be independent should have the guts to be a pain in the neck and act independently," and that Delaware corporations should have "good corporate practices in place" that were implemented "genuinely and in good faith."[20] Chief Justice Veasey also frankly acknowledged the new legal environment in light of the corporate scandals, noting that "changes in corporate governance that [have developed] through the voluntary best practices codes, for example, or through the New York Stock Exchange listing requirements[,] have created a new set of expectations for directors."[21] According to Chief Justice Veasey, this in turn will change how Delaware courts will "look at these issues" of corporate behavior.[22]

Vice Chancellor Leo E. Strine, Jr. of the Delaware Court of Chancery, one of the more prolific writers on corporate law issues, has made similar points about Delaware's reaction to the corporate scandals and the ensuing reforms. Writing before *Disney*, but specifically commenting on Enron's aftermath, Vice Chancellor Strine viewed the corporate scandals as generating "increased pressure on courts to examine carefully the plausibility of director claims that they were able to devote sufficient time to their duties to have carried them out in good faith."[23] Perhaps even more troubling for directors seeking deference from Delaware courts, Vice Chancellor Strine addressed the possibility of a similar examination of decision-making in a change-of-control situation, noting that while the recent corporate scandals did not arise in the takeover context, they challenge the assumption of directors' competence in such a context.[24] Continuing, Vice Chancellor Strine wrote that the corporate scandals weakened other arguments in favor of deference to directors, including the notion that the efficient market theory justifies and legitimizes directors' decision-making: since the markets were not able to detect the alleged corporate abuses, more skepticism should be given to directors' decision-making in a takeover situation.[25]

One undercurrent to the case law and commentary is that although such corporate governance reforms as the Sarbanes-Oxley Act of 2002 were enacted as changes to federal law, they will have a major impact on, and be a threat to, state corporate law. Chancellor Chandler and Vice Chancellor Strine, in an unpublished article entitled "The New Federalism of the American Corporate Governance System," wrote that "if history is any guide, the active plaintiffs' bar will be creative and aggressive in deploying the [corporate governance reforms] as a tool in shareholder litigation under state law."[26] Additionally, Chandler and Strine foresee the possibility of new causes of action stemming from the fiduciary duties created by the corporate governance reforms, stating that "[t]here will be some legitimate pressure on state courts to respond with a measure of receptivity" to claims of a breach of fiduciary duties created by the corporate governance reforms.[27]

The two jurists view the traditional balance of power in corporate law, which gave the states a leading role, as having "served investors and the public well."[28] However, unless the states recognize and aggressively adhere to the spirit of the corporate governance reforms, the traditional state role is in grave danger of being usurped by the federal government and the stock exchanges.[29] As an example of an area where the states may need to take the lead aggressively, both Chandler and Strine's unpublished article and Strine's piece on the implications of Enron discuss the advantage held by incumbent directors in election battles.[30] Since the two articles were published, the Securities and Exchange Commission has addressed this area.[31] Such action by the SEC merely highlights the critical nature of prompt state action.

In addition to Chandler and Strine, others have noted the growing influence of federal corporate law as a threat to the traditional Delaware role, and while the general subject of the federalization of American corporate law will not be discussed here, federalization is a useful point of inquiry to examine Delaware's behavior.[32] As Professor Stephen Bainbridge has written, the corporate scandals have only hastened the expansion of national corporate governance standards "that displace state corporate law," which has had traditional primacy.[33] According to Professor Bainbridge, under the Commerce Clause the federal government has the right to make national corporate law, and the issue is not constitutional but one of "prudency and federalism."[34] However, empirical studies have not shown any shareholder gains from corporate governance reforms, and there are strong arguments in favor of "competitive federalism," which encourages corporations to choose the legal framework under which they operate.[35] Thus, according to Professor Bainbridge, the "substance of corporate governance standards [are best] left to the states."[36]

Conclusion

Few matters are more critical to directors than ensuring that they are not held personally liable for their official actions. A trend of Delaware courts to find widespread liability for breaches of the duty of loyalty in non-self-dealing contexts, thus placing directors' actions outside of §102(b)(7)'s protections, would have grave consequences. If this occurs, directors will be even more reluctant to serve on boards than they already are, which should be unwelcome news to proponents of effective corporate governance.

By itself, *Disney* may not be of huge significance. The rhythms of Delaware corporate case law occasionally change from pro-director to pro-shareholder and then back again. However, *Disney* and the ancillary commentary may well be an accurate prediction of the state-law response to the corporate scandals, and show recognition by Delaware of the new skepticism of corporate actions that is shared by regulators and the public. If so, then *Disney* and the push for a tighter rein on director behavior, as part of the larger mosaic of state responses to the corporate scandals and encroaching federalization of corporate law, makes this a watershed moment. Without a system that ensures that directors will be able to serve without constant fear of liability, the framework that Delaware has nourished so well, for so long, may be imperiled. Perhaps the duty of good faith should be examined more skeptically, as it was in *Disney* and as suggested by the commentary; but equity and reason would seem to call for such an examination to be accompanied by higher standards for plaintiffs, or an expansion of the limitations on director liability provided by §102(b)(7).

Leading Delaware jurists note that states are under pressure to respond to the corporate scandals and reforms, and state law changes further shielding directors from liability seem unlikely at the present time. However, the states should not let their actions be governed solely by popular perceptions and events. If they do, the forces of government regulation will drive further and further towards a harmonization of state law to match the federal mood. If Delaware merely tightens its standards to keep up with the spirit of federal legislation, the result may be state corporate law supremacy on paper—but a reality of states marching to the federal drum. This would be a pyrrhic victory, and far from the ideal of "competitive federalism" which benefits both economic and personal liberty.

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Footnotes

1 Paula Moore, *Coors Explains Delaware Reincorporation Plan*, Denver Business Journal, August 29, 2003.

2 Other states have established other specialties—for example, Maryland is the leading jurisdiction of incorporation for real estate investment trusts, or REITs. Heather Harlan, *Maryland is the right place for plenty of REITs*, Washington Business Journal, March 24, 2000. However, relatively few states even attempt to keep a state-of-the-art corporations law on their books, let alone have Delaware's volume of precedent. The practical result is that Delaware precedent is extremely persuasive and extensively cited in nearly all jurisdictions. Carol Vinzant, Why Do Corporations Love Delaware So Much? FORTUNE, February 1, 1999.

3 Jill E. Fisch, *The Peculiar Role of the Delaware Courts in the Competition for Corporate Charters*, 68 U. Cin. L. Rev. 1061 (2000).

4 After the Deleware Chancery Court's decision in City Capital Assocs. Ltd. Partnership v. Interco Inc., 551 A.2d 787 (Del. Ch. 1988), (hereinafter *Interco*), which limited the takeover defenses that a target company could use, Martin Lipton, founding partner of Wachtell, Lipton, Rosen & Katz, strongly criticized Delaware and said "[p]erhaps it is time to migrate out of Delaware." Paramount Communication v. Time, Inc., 571 A.2d 1140 (Del. 1990), overruled Interco. Jeffrey Gordon, *Markets and the Courts*, 91 Colum. L. Rev. 1931, 1958-1959 (1991). It has been reported in the press that Lipton's statement was in response to the decision in Smith v. Van Gorkom, 488 A.2d 858

(Del. 1985), but this is incorrect; see Marc Gunther, *Boards Beware*, FORTUNE, November 10, 2003.

[5] In re Walt Disney Co. Derivative Litigation, C.A. No. 15452, Chandler, C. (Del. Ch. May 28, 2003) (hereinafter *Disney*).

[6] The duty of loyalty and the duty of care are generally considered the twin fiduciary duties of Delaware corporate law. The duty of loyalty encompasses the duty of good faith, which is at the heart of the Disney case. The Court of Chancery made clear in *Emerald Partners v. Berlin* that the duty of good faith "is subsumed within the duty of loyalty, as distinguished from being a compartmentally distinct fiduciary duty of equal dignity with the two bedrock fiduciary duties of loyalty and due care." Emerald Partners v. Berlin, C.A. No. 9700, 2001 Del. Ch. LEXIS 20, at *87 n.63 (Del. Ch. Feb. 7, 2001). Another obligation under the duty of loyalty, in addition to good faith, is the obligation not to engage in self-dealing. The duties of loyalty and good faith are referred to in this article interchangeably, unless otherwise noted.

[7] See generally Donald E. Pease, *Aronson v. Lewis*: *When Demand Is Excused and Delaware's Business Judgment Rule*, 9 DEL. J. CORP. L. 39 (1984).

[8] See generally Justice Henry Ridgely Horsey, *The Duty of Care Component of the Delaware Business Judgment Rule*, 19 DEL. J. CORP. L. 971 (1994).

[9] See Bud Roth, Entire Fairness Review for a "Pure" Breach of Duty Care: Sensible Approach or Technicolor Flop?, 3 DEL. L. REV. 145, 171-173 (2000).

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

[11] *Id*.

[12] Richards, Layton & Finger, Recent Delaware Corporate Law Decisions, available at <http://www.rlf.com/spot072503.htm>.

[13] *Id*.

[14] *In re The Walt Disney Company Derivative Litigation,* No.15452 (Del. Ch. Oct. 7, 1998),

[15] *Id.*

[16] Brehm v. Eisner*,* 746 A.2d 244 (Del. 2000).

[17] DEL. CODE ANN. tit.8, § 220 gives shareholders the right to inspect the books and records of a Delaware corporation for a proper purpose.

[18] *Disney*, slip op. at 28.

[19] *What's Wrong with Executive Compensation*: A Round-table Moderated by Charles Elson, HARV. BUS. REV., Jan. 2003.

[20] *Id*.

[21] *Id*.

[22] *Id.*

[23] Leo E. Strine, Jr., *Derivative Impact? Some Early Reflections on the Corporation Law Implications of the Enron Debacle*, 57 BUS. LAW. 1371 (2002) (hereinafter, Strine, Derivative Impact). Enron was an Oregon corporation, WorldCom a Georgia corporation and Tyco a Bermuda corporation.

[24] *Id.*

[25] *Id.*

[26] Chancellor William B. Chandler and Vice Chancellor Leo E. Strine, Jr., *The New Federalism of the American Capital System: Preliminary Reflections of Two Residents of One Small State*, available at <http://www.stern.nyu.edu/clb/2003/03-001.pdf>.

[27] *Id*.

[28] *Id*.

[29] *Id.*

[30] *Id.*; Strine, Derivative Impact, supra note 23.

[31] Cf. Stephen M. Bainbridge, A Comment on the SEC's Shareholder Access Proposal, infra.

[32] For an early discussion of this issue, see Alan R. Palmiter, *The CTS Gambit: Stanching the Federalization of Corporate Law*, 69 WASH. U. L.Q. 445 (1991). The role of state regulators in policing corporate activities is an unknown factor. It is unclear whether actions by state officials such as New York Attorney General Elliot Spitzer and Massachusetts Commonwealth Secretary William Galvin will strengthen the arguments for increasing federalization of corporate law, or will instead be persuasive evidence for the wisdom of leaving power to the states. In either case, the state regulators' claim of jurisdiction over companies regardless of their state of incorporation is a challenge to the traditional notions of corporate sovereignty and must be addressed within the context of the assumed primary legal position of a state over its domestic corporations. However, this challenge is still in its incipient stages, and its result may depend on the ability of the states to respond to the federal challenge to their traditional corporate law role.

[33] Stephen M. Bainbridge, *The Creeping Federalization of Corporate Law*, REGULATION, Spring 2003.

[34] *Id*.

[35] *Id.*

[36] *Id.*