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The Role of Good Faith in Delaware: How Open-Ended Standards Help Delaware Preserve Its Edge

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I. INTRODUCTION

Ever since the Delaware Chancery Court's 2003 decision in *In re Walt Disney Co. Derivative Litigation* ("*Disney II*"),[1] commentators have struggled to discern meaning in the court's sudden embrace of "good faith" as an avenue for director liability for the breach of fiduciary duty. In large part, such efforts were attempts to read between the lines and impart some meaning where conflicting judicial opinions had created a doctrinal chasm. Early assessments of *Disney II* speculated that "good faith" might serve as a way to incorporate the concept of "scienter" from securities law into the corporate law regime, by equating reckless or intentionally harmful decisions with actions "not in good faith."[2] Other scholars suggested that "good faith" was a tool—a concept that could be manipulated to serve the judiciary's interests in sending messages in controversial cases without creating enduring legal standards that would govern future controversies.[3]

Since *Disney II*, Delaware's good faith doctrine has taken several twists and turns. In 2005, after a trial on the merits, Chancellor Chandler exonerated all of the Disney defendants from liability, concluding that the plaintiffs had failed to prove the allegations contained in their complaint.[4] Although Chancellor Chandler found that the conduct of Disney's directors "fell significantly short of the best practices of ideal corporate governance,"[5] he concluded such conduct amounted to negligence at worst and did not constitute the kind of conduct that was beyond the protection of the firm's exculpatory charter provision.[6] The Delaware Supreme Court affirmed the trial court's decision, endorsing Chancellor Chandler's interpretation of good faith.[7]

After the *Disney* trial decision, the early interpretations of the new meaning of good faith remained plausible. The trial decision did not move the bar much; the court simply ruled that the *Disney* plaintiffs had not met the high standard for establishing director liability in the due care context. As such, the trial court decision left open the possibility of director liability for due care breaches, while making clear

1. 825 A.2d 275 (Del. Ch. 2003). In *Disney II*, the Delaware Chancery Court denied defendants' motion to dismiss a shareholder complaint against Disney directors for the breach of their fiduciary duties in connection with their approval of a lucrative employment contract for President Michael Ovitz and a subsequent decision to terminate Ovitz's employment and award him $140 million in severance pay. Several years earlier, the same judge had summarily dismissed an earlier version of the complaint in the dispute. *See In re* Walt Disney Co. Derivative Litig. (*Disney I*), 731 A.2d 342 (Del. Ch. 1998).

2. *See* Hillary A. Sale, *Delaware's Good Faith*, 89 Cornell L. Rev. 456, 488–94 (2004).

3. *See* Sean J. Griffith, *Good Faith Business Judgment: A Theory of Rhetoric in Corporate Law Jurisprudence*, 55 Duke L.J. 1, 4–8 (2005).

4. *In re* Walt Disney Co. Derivative Litig. (*Disney III*), 907 A.2d 693 (Del. Ch. 2005).

5. *Id.* at 697.

6. *Id.* at 760. Like most Delaware corporations, Disney's corporate charter contained a provision exonerating, or exculpating, its directors from monetary liability for breach of fiduciary duty, other than those breaches specifically excluded by section 102(b)(7) of the Delaware General Corporation Law. Among other exclusions, section 102(b)(7) forbids a corporation's exculpation of directors from liability for "acts or omissions not in good faith." Del. Code Ann. tit. 8, § 102(b)(7) (2001).

7. *In re* Walt Disney Co. Derivative Litig. (*Disney IV*), 906 A.2d 27, 63–68 (Del. 2006).

that the standard (an intentional failure to act in the face of a known duty to act) would remain exceedingly difficult to meet.[8]

Just as a consensus was starting to emerge on the meaning of good faith, the Delaware Supreme Court's decision in *Stone v. Ritter* upended the conventional view.[9] In *Stone*, the court announced that, contrary to *Disney*'s dicta, allegations of even an egregious breach of the duty of care were insufficient to overcome section 102(b)(7)'s bar on a director's monetary liability.[10] Instead, to the surprise of most observers, the supreme court announced that *Caremark* claims alleging a failure to monitor were loyalty claims and that a mere breach of duty of care would not result in a director's personal liability to the corporation.[11]

In theory, *Stone* expanded the scope of a director's duty of loyalty to the corporation. For this reason, many scholars have lauded the new location of good faith within the loyalty rubric.[12] These scholars maintain that this newer formulation of good faith enhances directors' loyalty obligations by broadening the scope of loyalty beyond simply avoiding conflicts of interest.[13] They maintain that this newer conception of loyalty better comports with good governance ideals than earlier conceptions commonly credited by courts.[14]

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8. *See Disney III*, 907 A.2d at 755.

9. 911 A.2d 362 (Del. 2006). In *Stone*, the court assessed shareholders' allegations that directors of AmSouth Bancorporation had breached their fiduciary duties by failing to monitor the corporation's compliance with federal bank secrecy and anti-money laundering rules. *Id.* The corporation paid $50 million in fines in connection with these violations. *Id.* at 371. The Delaware Supreme Court upheld the Chancery Court's dismissal of the complaint and also redefined the scope of good faith, declaring that good faith was not an independent duty, and holding instead that the duty to act in good faith was a subset of the duty of loyalty. *Id.* at 369–70.

10. *Compare id.* at 369, *with Disney III*, 907 A.2d at 745–46 (stating that good faith is intertwined with duties of care and loyalty) *and Disney IV*, 906 A.2d at 66 ("[T]he universe of fiduciary misconduct is not limited to either disloyalty in the classic sense . . . or gross negligence. Cases have arisen where corporate directors have no conflicting self-interest in a decision, yet engage in misconduct that is more culpable than simple inattention or failure to be informed of all facts material to the decision . . . . [F]iduciary conduct of this kind, which does not involve disloyalty (as traditionally defined) but is qualitatively more culpable than gross negligence, should be proscribed. A vehicle is needed to address such violations doctrinally, and that doctrinal vehicle is the duty to act in good faith.").

11. *Stone*, 911 A.2d at 367, 369–70. *In re Caremark International Inc. Derivative Litigation* is the classic case in which shareholders sought recovery of fines and penalties Caremark had paid for violations of federal law. The plaintiffs sought to hold Caremark's directors liable for the corporation's losses on the theory that directors had failed to adequately monitor the corporation's compliance with law. In approving the parties' settlement, Chancellor Allen reasoned that although directors have an obligation to establish a system for monitoring a corporation's compliance with the law, decisions reached in good faith regarding the design and scope of such a system are beyond judicial scrutiny under the business judgment rule. *In re* Caremark Int'l Inc. Derivative Litig., 698 A.2d 959 (Del. Ch. 1996).

12. *See, e.g.*, Christopher M. Bruner, *Good Faith, State of Mind, and the Outer Boundaries of Director Liability in Corporate Law*, 41 Wake Forest L. Rev. 1131 (2006); Andrew S. Gold, *The New Concept of Loyalty in Corporate Law*, 43 U.C. Davis L. Rev. 457 (2009); Claire A. Hill & Brett H. McDonnell, Stone v. Ritter *and the Expanding Duty of Loyalty*, 76 Fordham L. Rev. 1769 (2007).

13. Hill & McDonnell, *supra* note 12, at 1770, 1779–80; Gold, *supra* note 12, at 461–63.

14. *See* Hill & McDonnell, *supra* note 12, at 1780–88, 1796; Gold, *supra* note 12, at 526–28.

This article takes a different view of Delaware's good faith jurisprudence. Rather than seeking to unpack good faith's meaning through intense doctrinal analysis, the article analyzes developments in good faith jurisprudence from a political perspective, with the view that federal regulatory developments have impacted significantly the development of the good faith doctrine. Acknowledging the political context surrounding these decisions helps to explain the jurisprudential shifts that otherwise are difficult to square. This article shows how variations in the courts' interpretation of good faith correspond with shifts in the nation's political and economic climate. When federal governance reforms loomed in 2002 and 2003 after major corporate scandals, good faith assumed greater prominence in Delaware. As the federal preemptive threat faded, courts retired this weapon from their arsenal.

Part II of the article explains how good faith first emerged as an independent duty that appeared to pose a significant risk of personal liability for directors. It links this phoenix-like rise of good faith to the 2001–2002 corporate governance scandals exemplified by the WorldCom and Enron frauds. This Part also reviews the courts' subsequent retreat from the recognition of an independent duty of good faith. It ties this development to the dissipation of what seemed to be a real threat of federal preemption and the emergence of a political backlash against federal corporate regulation that afforded Delaware space to maintain more permissive corporate governance standards. Part III takes account of recent political developments in the aftermath of the 2008 financial crisis. It notes expanding federal engagement on major governance issues and details the response of Delaware's legislature and its courts. This Part demonstrates that Delaware's legislature took action aimed at deterring further federal regulation on proxy access. However, despite expanding federal engagement on executive compensation matters, Delaware courts have yet to signal a shift in fiduciary doctrine. An important exception to this stasis is the Delaware Court of Chancery decision in *In re Citigroup Derivative Litigation,* which allowed a typically unpromising waste claim to survive a motion to dismiss.[15]

II. A POLITICAL ACCOUNT OF GOOD FAITH JURISPRUDENCE

When viewed through the prism of national politics, the helter-skelter nature of Delaware's good faith doctrine begins to develop coherence. Through this prism, Delaware's prime movers in corporate law—the bar, the legislature, and the judiciary—seek always to stay a step ahead of federal regulators on governance issues. During good economic times when shareholders and citizens are happy, Delaware's corporate policies can afford to be more lax, a posture that satisfies corporate managers and helps protect Delaware's franchise.[16] However, when scandals erupt or the economy sours, restrictive federal legislation and new rules are proposed to address the crisis.[17]

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15. 964 A.2d 106 (Del. Ch. 2009). *See infra* text accompanying notes 148–54.

16. *See* William W. Bratton & Joseph A. McCahery, *The Equilibrium Content of Corporate Federalism*, 41 Wake Forest L. Rev. 619, 634–35 (2006).

17. *See id.* at 635; *see also* Stuart Banner, *What Causes New Securities Regulation? 300 Years of Evidence*, 75 Wash. U. L.Q. 849, 850 (1997).

When new rules loom on the federal agenda, they threaten to undercut the appeal of Delaware law and might limit the power of Delaware's judiciary by taking certain issues "off the table."[18] In response to these threats, policymakers in Delaware appear to work in tandem to discourage new federal mandates while advocating for the preservation of Delaware's laissez-faire approach on governance issues.[19] Thus, in Delaware, courts tend to tighten fiduciary standards when federal reforms seem imminent. Judges tout these tougher standards in extra-judicial writings to show the public and federal policymakers that they take governance matters seriously.[20]

A. The Political Framework

The view that shifts in Delaware jurisprudence and legislative amendments form part of an effort to maintain the state's dominance in the race for corporate charters is a common refrain in the corporate law literature, dating back at least as far as William Cary's famous article in which he coined the term "race for the bottom."[21] More recently, scholars have observed that Delaware's dominance in corporate law is threatened more by developments at the federal level than by any competitive efforts advanced in other states.[22] Proponents of this view suggest that many shifts in state corporate law correlate with efforts brewing in Congress or the Securities and

18. *See* Marcel Kahan & Edward Rock, *Symbiotic Federalism and the Structure of Corporate Law*, 58 Vand. L. Rev. 1573, 1588–89 (2005); Mark J. Roe, *Delaware's Competition*, 117 Harv. L. Rev 588, 591–92 (2003).

19. *See, e.g.*, William B. Chandler III & Leo E. Strine, Jr., *The New Federalism of the American Corporate Governance System: Preliminary Reflections of Two Residents of One Small State*, 152 U. Pa. L. Rev. 953, 978–79 (2003) ("From the perspective of Delaware and other states, the 2002 Reforms are somewhat problematic because they supplement our principles-based, substantive corporation laws with a variety of specific requirements that are not part of any overall system of corporate governance."); E. Norman Veasey, *State-Federal Tension in Corporate Governance and the Professional Responsibilities of Advisors*, 28 J. Corp. L. 441, 444 (2003) (referring to Chandler and Strine's article and expressing concern that federal mandates "may tend to destabilize some of the features of Delaware law that benefit stockholders"); Sean J. Griffith & Myron T. Steele, *On Corporate Law Federalism: Threatening the Thaumatrope*, 61 Bus. L. 1, 2 (2005) ("We argue that [the] back-and-forth between the vague and the concrete, the stringent and the lax, enables the states to generate a more subtle and effective form of regulation than the federal pattern of enacting governance mandates."). Authors Chandler and Strine are Chancellor and Vice Chancellor of the Delaware Court of Chancery, respectively. Authors Steele and Veasey were each serving as Chief Justice of the Delaware Supreme Court at the time they wrote the referenced articles.

20. *See* Charles Elson, *What's Wrong with Executive Compensation? A Roundtable Moderated by Charles Elson*, Harv. Bus. Rev., Jan. 2003, at 68, 76 ("In particular, I urge you to read our opinion in the *Disney* case . . . . In the end, we said that the shareholder group's arguments were not good enough to justify setting entirely aside the ruling of the Court of Chancery in favor of the Disney board. We did say, though, that we would be willing to allow the stockholders to file a new pleading."); *see also* Veasey, *supra* note 19, at 447 (disputing the "myth" that there is no limit in Delaware on "what compensation committees may award CEOs and other senior managers"); Kahan & Rock, *supra* note 18, at 1575.

21. William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 Yale L.J. 663, 666 (1974); *see also* Comment, *Law for Sale: A Study of Delaware Corporation Law of 1967*, 117 U. Pa. L. Rev 861 (1969).

22. *See, e.g.*, Roe, *supra* note 18, at 590, 639–42, 644–46; Renee M. Jones, *Rethinking Corporate Federalism in the Era of Corporate Reform*, 29 J. Corp. L. 625, 628–39 (2004); Kahan & Rock, *supra* note 18, at 1575.

Exchange Commission (SEC) to tighten conduct standards for public company officials.[23]

Evidence of a correlation between doctrinal shifts and federal reform was most stark as the nation responded to the revelation of massive fraud at some of the country's most revered companies.[24] Although the names Enron and WorldCom are most closely associated with the 2001–2002 scandals, many other well-known companies were revealed to have falsified financial reports at the advent of the new century.[25] Congress responded to these accounting scandals by holding hearings and proposing legislation aimed at reforming corporate America. President George W. Bush joined the efforts with a pledge to restore corporate responsibility and rid corporate America of the "bad apples in the barrel."[26]

This hostile rhetoric aimed at corporate officials coupled with a prolonged stock market slide raised concerns among Delaware's leaders that federal reforms might encroach significantly on state terrain.[27] This fear became reality when Congress enacted the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley").[28] The legislation included broad reforms aimed at improving financial reporting practices at publicly traded corporations.[29]

Sarbanes-Oxley imposed a slew of new requirements on directors of publicly traded companies. First, it set out new rules governing the structure and duties of the audit committee of the board of directors. Under the new law, all members of a listed company's audit committee must be independent of management,[30] and at least one audit committee member is expected to be a financial expert.[31] Sarbanes-Oxley requires that the audit committee have the authority to hire and fire the auditors, hire

23. *See* Jones, *supra* note 22, at 643–46.

24. *See* Rebecca Smith, *Enron Files for Chapter 11 Bankruptcy, Sues Dynegy*, Wall St. J., Dec. 3, 2001, at A3; *see also* Simon Romero & Riva D. Atlas, *WorldCom's Collapse: The Overview; Extra Level of Scrutiny in WorldCom's Bankruptcy*, N.Y. Times, July 23, 2002, at C1.

25. *See* Lawrence A. Cunningham, *The Sarbanes-Oxley Yawn: Heavy Rhetoric, Light Reform (And It Just Might Work)*, 35 Conn. L. Rev. 915, 936–37 (2003).

26. *See* Howard Fineman, *Living Politics: McCain Remains Bush's Top Nemesis*, Newsweek, July 10, 2002, *available at* http://www.newsweek.com/2002/07/09/living-politics-mccain-remains-bush-s-top-nemesis.html; Leslie Wayne, *Corporate Conduct: The Reaction; A Talk on Corporate Integrity Heard in the Street and the Suite*, N.Y. Times, July 10, 2002, at C1; Jim Landers & G. Robert Hillman, *Bush Vows Corporate Crackdown; Lawmakers Say Public is Insisting on a Remedy for Scandals*, Dallas Morning News, July 9, 2002, at 1A.

27. *See, e.g.*, Leo E. Strine, Jr., *Derivative Impact? Some Early Reflections on the Corporation Law Implications of the Enron Debacle*, 57 Bus. Law. 1371, 1372 (2002) (remarking that Congress may be tempted to federalize key elements of state corporate law and warning of the "risks" of such preemption).

28. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 11 U.S.C., 15 U.S.C., 18 U.S.C., 28 U.S.C., and 29 U.S.C. (2006)).

29. *See President Bush Signs into Law Broad Accounting Reform Legislation*, 34 Sec. Reg. & L. Rep. (BNA) 1303 (Aug. 5, 2002).

30. Sarbanes-Oxley Act of 2002 § 301, 15 U.S.C. § 78j-1 (2006).

31. Sarbanes-Oxley Act of 2002 § 407.

its own experts, and set its own budget.[32] Finally, in section 404, Sarbanes-Oxley created new requirements for an annual audit of a corporation's internal controls.[33]

Sarbanes-Oxley also banned several practices permitted under state law. Most notably, it bans corporate loans to directors and executives, a practice permitted under Delaware corporate law.[34] These new corporate governance standards represented a sharp departure from Delaware's traditional laissez-faire approach to corporate oversight. With these changes, Sarbanes-Oxley "federalized" significant portions of American corporate law, displacing permissive state law rules with new mandatory federal requirements.[35] Sarbanes-Oxley thus set the stage for a public relations campaign by Delaware jurists that seemed aimed at preserving their sphere of influence.[36] Delaware judges waged this campaign through public speeches, law review articles, and most importantly by effecting a shift on important doctrinal tenets during the period directly following the big governance scandals and the enactment of Sarbanes-Oxley.[37] These efforts seemed designed to persuade the public and national policymakers that Delaware was up to the task of addressing corporate malfeasance, making further preemption of state law unnecessary.[38]

This endeavor by Delaware jurists is a delicate balancing act. Judges need to bolster their legitimacy by showing they are up to the task of applying meaningful standards and protecting shareholder interests and the national interest in a smoothly functioning economy. At the same time, Delaware's policymakers are mindful of the importance of the corporate franchise and can ill afford to alienate the corporate managers that are the source of franchise fees that fill the state's coffers. This tension between the pursuit of political legitimacy and satisfying the parochial interests of the Delaware citizenry by protecting the corporate franchise goes far in explaining the judiciary's preference for indeterminate, open-ended jurisprudence that allows judges to manage the competing concerns of these very different audiences.

On this view of corporate federalism, the new "good faith" doctrine embraced fleetingly in *Disney* has served mostly as a ploy that allowed Delaware's judiciary to look tough without having to act tough. The court invoked "good faith" to help forestall further federal governance reforms that might threaten Delaware as the

32. *Id.* § 301.

33. *Id.* § 404.

34. *Compare id.* § 402, *with* Del. Code Ann. tit. 8, § 122(14) (2009) (permitting a corporation to "lend money for its corporate purposes").

35. *See* Stephen M. Bainbridge, *The Creeping Federalization of Corporate Law*, 26 Reg. 26, 28 (2003).

36. *See* Jones, *supra* note 22, at 643–47.

37. *See id.*; *see, e.g.*, *Disney II*, 825 A.2d 275 (Del. Ch. 2003); *In re* Oracle Corp. Derivative Litig., 824 A.2d 917 (Del. Ch. 2003) (denying a special litigation committee's motion to dismiss a shareholder derivative suit against Oracle's directors).

38. *See, e.g.*, Elson *supra* note 20, at 77 ("I trust at the end of the day, the system will correct itself. If we don't fix it, Congress will, but I hope they've gone as far as they're going to have to go." (quoting E. Norman Veasey)).

nation's primary corporate regulator. The judiciary later retreated from the same standard after the threat of federal preemption had receded.

B. The Disney Pirouettes

It is difficult to make sense of the emergence of good faith without first recapping the legal drama inspired by the Walt Disney Company's ill-fated association with super-agent Michael Ovitz. The familiar tale began in 1995 when Disney Chief Executive Officer Michael Eisner hired his good friend Michael Ovitz as his second in command.[39] Ovitz received a lucrative employment contract that included unusual severance provisions. Under the terms of the contract, if Ovitz were terminated without cause (a non-fault termination) he was entitled to receive his full salary and maximum bonus for the remainder of the term plus the immediate vesting of his stock options.[40] By all accounts, Ovitz's performance at Disney was dismal and Eisner was soon looking for a way out of the contract. When efforts to arrange for an amicable parting failed, Eisner granted Ovitz a non-fault termination, handing over $140 million in severance despite Ovitz's poor performance.[41]

Disney shareholders sued, claiming that the directors had breached their fiduciary duties by approving Ovitz's agreement without informing themselves of its true costs. They argued the contract guaranteed payment for failure as it offered Ovitz more in compensation the sooner he was terminated by Disney.[42] Plaintiffs also maintained that the directors breached their fiduciary duties by standing idly by as Eisner arranged for his friend's lucrative departure. In sum, the plaintiffs claimed Disney's directors breached their duties of loyalty and care and wasted corporate assets.[43]

In 1998, in *In re Walt Disney Co. Derivative Litigation* ("*Disney I*"), the Delaware Court of Chancery dismissed the plaintiffs' complaint, holding that the challenged board decisions were protected by the business judgment rule.[44] In 2000, the Delaware Supreme Court affirmed this ruling.[45] However, the supreme court reversed one aspect of *Disney I* to permit the plaintiffs to amend their complaint and replead allegations that Disney directors had breached their fiduciary duties by failing to become fully informed when they approved the Ovitz agreement and the non-fault termination.[46]

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39. *Disney I*, 731 A.2d 342, 352 (Del. Ch. 1998).

40. *Id.*

41. *Id.* at 350.

42. *See id.* at 352.

43. *Id.* at 353.

44. *Id.* at 362, 364.

45. Brehm v. Eisner, 746 A.2d 244, 249 (Del. 2000).

46. *Id.* at 267.

In May 2003, Chancellor Chandler ruled on the plaintiffs' second amended complaint in *Disney II*.[47] In a surprising decision, he found that the amended complaint sufficiently alleged that Disney's directors failed to act in good faith such that the company's exculpatory charter provision might not shield them from liability.[48] According to the Chancellor, the new complaint supported the claim that Disney directors had consciously disregarded their duties, adopting a "'we don't care about the risks' attitude" on an important corporate decision.[49] Thus, if the plaintiffs were able to prove these allegations at trial, the directors would face personal liability for the harm their omissions caused to the corporation.

In 2005, after thirty-seven days of trial, Chandler ruled on the merits of plaintiffs' claims.[50] He concluded that the Disney directors' conduct, while perhaps regrettable,[51] did not rise to the level of "bad faith" conduct.[52] In this opinion, the Chancellor laid out the types of conduct that might constitute acts and omissions not in good faith, beyond the protection of an exculpatory charter provision. He held that "*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."[53] The plaintiffs appealed to the Delaware Supreme Court, which in 2006 affirmed the trial court decision, bringing to an end one of the most dramatic corporate controversies in recent memory.[54] The Delaware Supreme Court endorsed Chancellor Chandler's definition of good faith and agreed that the Disney directors satisfied that standard.[55]

The underlying basis for these see-sawing assessments of the merits of the *Disney* plaintiffs' claims comes into sharper focus when placed against the backdrop of the major corporate scandals that consumed the nation's attention throughout 2002 and 2003. When the Enron and WorldCom scandals broke, judges spoke out publicly and warned corporate directors to take their duties more seriously.[56] In these public comments, they emphasized good faith and independence as concepts that might be

47. *Disney II*, 825 A.2d 275 (Del. Ch. 2003).

48. *Id.* at 286.

49. *Id.* at 289.

50. *Disney III*, 907 A.2d 693, 697 (Del. Ch. 2005).

51. *Id.* ("[T]here are many aspects of defendants' conduct that fell significantly short of the best practices of ideal corporate governance.").

52. *Id.* at 760 (holding that the directors "did not act in bad faith, and were at most ordinarily negligent, in connection with the hiring of Ovitz and the approval of [his contract]"). In his opinion, Chancellor Chandler equated the statutory phrase "not in good faith" with "bad faith" conduct, which he proceeded to define despite the fact that the term "bad faith" does not appear in section 102(b)(7). *See generally* Elizabeth A. Nowicki, *A Director's Good Faith*, 55 Buff. L. Rev. 457, 528–34 (2007).

53. *Disney III*, 907 A.2d at 755.

54. *Disney IV*, 906 A.2d 27, 35–36 (Del. 2006).

55. *Id.* at 67–68.

56. *See, e.g.*, Strine, *supra* note 27, at 1393 (warning that "[a] decision to become the director of a public corporation should not be undertaken lightly").

tweaked in ways that would expand the scope of director culpability beyond conventional limits.

For example, in a roundtable discussion published in the *Harvard Business Review*, Delaware Supreme Court Chief Justice Norman Veasey observed that "if directors claim to be independent . . . and don't do so, or if they are disingenuous or dishonest about it, it seems to me that the courts in some circumstances could treat their behavior as a breach of the fiduciary duty of good faith."[57] Similarly, Vice Chancellor Leo E. Strine, Jr. advised, "the warnings to them have been too widespread for public company directors to claim that their acceptance of the position did not carry with it a burden of making a good faith effort."[58] Of particular relevance, Chief Justice Veasey pointed to his court's 2000 *Brehm v. Eisner* decision as evidence of its close oversight of board conduct.[59] He advised directors "to read our opinion in the *Disney* case which ties in with some of the things that have been said here . . . we felt there could have been something in it. In particular did Disney's board act in good faith in agreeing to Mr. Ovitz's compensation?"[60]

This heated extra-judicial rhetoric in the immediate aftermath of the 2001–2002 accounting scandals helps explain why Chancellor Chandler abruptly reversed course between his initial 1998 dismissal of the case in *Disney I* and his more sympathetic assessment of plaintiffs' claims in his 2003 *Disney II* decision. With *Disney*'s odd procedural history, the only way around a dismissal of the action was to credit plaintiffs' allegations that Disney's directors had failed to act in good faith when they approved Michael Ovitz's employment agreement and acceded to his "non-fault" termination. To advance the case, Chancellor Chandler had few options other than to rely on good faith as a route to director liability.[61] Good faith loomed large because plaintiffs' allegations of conflicts of interest between Ovitz, Eisner, and Disney had been dispensed with in his earlier opinion and the supreme court upheld those aspects of his ruling.[62] This meant the *Disney* complaint could only survive the motion to dismiss if the court found well-pleaded plaintiffs' allegations that the Disney board had failed to act in good faith.

In summary, good faith emerged as a potential avenue for director liability in Delaware in 2003 with the Chancery Court's ruling in *Disney II*. Until *Disney II*,

57. Elson, *supra* note 20, at 76.

58. Strine, *supra* note 27, at 1394.

59. Elson, *supra* note 20, at 76.

60. *Id.*

61. The second amended complaint was before Chancellor Chandler on a motion to dismiss for failure to make demand. *Disney II*, 825 A.2d 275, 277 (Del. Ch. 2003). To show demand futility, plaintiffs had to plead facts creating a "reasonable doubt" that a majority of the directors were disinterested and independent or that under the facts alleged the directors were not entitled to the protection of the business judgment rule. *Id.* at 285 (citing Aronson v. Lewis, 473 A.2d 805, 814 (Del. 1984)). The amended complaint was being evaluated only under *Aronson*'s second prong. *Id.* at 285–86. Further, because Disney had an exculpatory charter provision, to survive a motion to dismiss, the allegations had to constitute non-exculpable conduct. *Id.* at 286.

62. *Disney I*, 731 A.2d 342, 356, 360–61 (Del. Ch. 1998).

most observers had assumed that section 102(b)(7) insulated directors completely from personal liability for due care breaches.[63] With *Disney II*, good faith, which had seemed like something of an afterthought, suddenly took on outsized significance. Commentators struggled to make sense of good faith as an independent duty. Most suggested good faith would capture conduct that lay at the intersection of loyalty and care and would be invoked when courts concluded directors had misbehaved in ways that did not involve a conflict of interest, but nonetheless failed to satisfy vague notions of minimum standards of board conduct.[64]

C. Good Faith After Disney

By late 2004, the threat of more extensive federal preemption of state corporate law appeared to have receded. The SEC had abandoned its proposed shareholder access rule and reform-oriented SEC Chair William Donaldson had been replaced by more management-friendly Christopher Cox.[65] Chief Justice Veasey, now retired, spearheaded the American Bar Association's efforts to amend the Model Business Corporation Act to accommodate majority voting by-laws, a modest adjustment to voting rules aimed at quelling governance activists' fervor for proxy access.[66] Delaware's Bar Association soon followed suit.

Soon thereafter, major U.S. business organizations launched a campaign to roll back some of the Sarbanes-Oxley Act's most onerous provisions. These efforts were reflected in three reports released by business groups in 2006 and 2007.[67] The main objective of these groups appeared to be to scale back Sarbanes-Oxley section 404.[68]

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63. Bruner, *supra* note 12, at 1144; Sale, *supra* note 2, at 462.

64. *See* Griffith, *supra* note 3, at 6, 44 ("The duties of care and loyalty have traditionally been viewed as distinct, with separate doctrinal requirements. Now, however, . . . good faith . . . suggests that there are situations in which the categories may be blended, allowing claims to survive when some but not all of the traditional doctrinal requirements have been met."). Chancellor Chandler seemed to embrace Griffith's description of good faith's meaning in a lengthy footnote in *Disney III*, 907 A.2d 693, 746 n.402 (Del. Ch. 2005) (asserting good faith is intertwined with the duties of care and loyalty and quoting Griffith's article).

65. *See* Stephen Labaton, *Is the S.E.C. Changing Course?* N.Y. Times, Mar. 1, 2007, at C1.

66. In the midst of the corporate governance crisis, shareholder advocates petitioned the SEC to adopt a rule allowing shareholders to place their own nominees for director in the management proxy statement. In response to this petition, the SEC proposed Rule 14a-11, the shareholder access rule; however, the proposal languished in the face of fierce opposition from the business community. For a more extensive discussion of the proxy access battle see discussion *infra* at notes 84–87.

67. Comm. on Capital Mkts. Regulation, Interim Report of the Committee on Capital Markets Regulation (Nov. 30, 2006); U.S. Chamber of Commerce, Commission on Regulation of U.S. Capital Markets in the 21st Century: Report and Recommendations (Mar. 2007), *available at* http://www.uschamber.com/reports/commission-regulation-us-capital-markets-21st-century; Sustaining New York's and the U.S. Global Financial Services Leadership (Jan. 2007), http://www.nyc.gov/html/om/pdf/ny_report_final.pdf.

68. Section 404 of Sarbanes-Oxley requires managers to annually assess and report on the quality and effectiveness of their firms' internal controls and requires the independent auditor to attest to management's report. Sarbanes-Oxley Act of 2002 § 404, 15 U.S.C. § 7262 (2006).

However, advocates also urged easing SEC rules and significant curbs on private securities litigation.[69] The bold recommendations contained in these reports suggest a climate in which business interests no longer feared expansion of federal corporate regulation, but instead held high hopes of undoing much of what Congress had implemented in 2002.

This backlash against Sarbanes-Oxley reflected the political atmosphere that prevailed during the Disney trial, which began in late 2004, and the 2006 supreme court rulings in *In re Walt Disney Co. Derivative Litigation* ("*Disney IV*")[70] and *Stone v. Ritter*. In *Stone*, the court emphasized the limits of *Disney*'s good faith dicta and tucked good faith neatly back into the loyalty rubric.[71] No longer was good faith an independent obligation, part of the "triad" of fiduciary duties.[72] No longer could an egregious violation of the duty of care be equated with the failure to act in good faith. This new posture provided further comfort to directors that ordinary due care breaches would not subject them to ruinous financial liability.

These more recent "good faith" rulings in *Stone* and *Lyondell Chemical Co. v. Ryan*[73] are consistent with a narrative of corporate doctrine shifting with the political and economic environment. After the Sarbanes-Oxley fervor receded and the economy showed signs of recovery, Delaware courts relaxed the tough stance on "good faith" that judges had assumed in earlier decisions. Judges accomplished this feat not by denying the significance of good faith, but by cabining it once again within the duty of loyalty.[74] After *Stone* so confined good faith, *Lyondell* made clear that the courts would not embrace a higher standard of director conduct than that which existed under *Caremark*.[75] Simply invoking *Caremark* could not provide a route around exculpation sufficient to allow a negligence-like claim to survive a motion to dismiss.

In this way, "good faith" has functioned as a vise, a tool that judges can tighten and loosen in response to economic and political controversies. This tool gives judges leeway to speak to multiple audiences simultaneously. To corporate activists and academics, strict standards and harsh rhetoric send one message. To corporate managers and their lawyers, ultimate absolution sends another.

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69. *See, e.g.*, U.S. Chamber of Commerce, *supra* note 67, at 16.

70. 906 A.2d 27 (Del. 2006).

71. 911 A.2d 362, 370 (Del. 2006); *see also* Hill & McDonnell, *supra* note 12, at 1769–70; Gold, *supra* note 12, at 459–60.

72. Hill & McDonnell, *supra* note 12, at 1769–70.

73. 970 A.2d 235 (Del. 2009). In *Lyondell*, the Delaware Supreme Court overruled a Chancery Court ruling denying defendants' motion for summary judgment. The plaintiffs had alleged that directors breached their duties by failing to ensure that the shareholders received the best price available in the merger of the company. They claimed the directors' failure to take any action when they became aware the company was "in play" constituted a failure to act in good faith. The Delaware Supreme Court reversed, holding that the plaintiffs had, at most, stated a claim for failure to act with due care and could prevail on a good faith claim only by proving the directors had "knowingly and completely failed to undertake their responsibilities." *Id.* at 243–44.

74. *Stone*, 911 A.2d at 369–70.

75. *Lyondell*, 970 A.2d at 240–41.

III. THE CLIMATE FOR GOVERNANCE REFORM AFTER THE FINANCIAL CRISIS

As this article asserts, Delaware has calibrated its good faith doctrine in response to economic and political conditions associated with the 2001–2002 accounting scandals, Sarbanes-Oxley, and the subsequent backlash against the new law. Given this assessment, it makes sense to consider whether Delaware is again tightening the fiduciary vise in response to public outcry related to the 2008 financial crisis. While there is little evidence of a dramatic shift in Delaware's fiduciary doctrine, legislative developments suggest Delaware has once again formulated corporate law policy with one eye on developments in Washington.

As with the Enron and WorldCom accounting scandals, the 2008 financial collapse and subsequent government bailout have significantly altered the federal corporate governance landscape. The ascendance of a Democratic administration and the change in leadership at the SEC also revived governance reforms that were rejected or tabled during the Bush Administration.[76] In addition to the normal policy shifts that occur when control of the presidency shifts parties, the bailout brought significant changes in the relationship between government and business. After the bailout, federal officials participated directly in business decisions of companies benefitting from government support. Officials overseeing the rescued firms replaced CEOs, selected new directors, forced mergers, and made key decisions on issues from closing car dealerships and product lines to overseeing the pay and perks of senior corporate executives.[77]

Two prominent issues now on the federal regulatory agenda encroach particularly on the territory traditionally conceived as part of the states' purview. Federal initiatives to provide shareholder access to the corporate proxy and oversee executive compensation practices present the most direct threat to Delaware's continued

76. For example, Congress took up legislation to authorize the SEC to regulate hedge funds and to adopt a proxy access rule, two issues the SEC had weighed but failed to act on during Chairman Cox's term. In *Goldstein v. SEC*, 451 F.3d 873 (D.C. Cir. 2006), a federal court invalidated the SEC's hedge fund rule adopted in 2004, and the SEC declined to take further action on the issue. In 2007, the SEC considered and rejected a proxy access rule. *See* discussion *infra* Part III.A; *see also* Renee M. Jones, *Will The SEC Survive Financial Regulatory Reform?*, 71 U. Pitt. L. Rev. 609, 615–16 (2010).

77. Among other business decisions, government regulators played a key role in replacing the CEO at General Motors Corp. and overseeing the reorganization of GM and Chrysler. The reorganization included the elimination of divisions and brands, the closing of car dealerships, and a brokered merger between Chrysler and Fiat. *See, e.g.*, Sheldon Alberts, *My Way or The Highway, Obama Says; Takes Ailing Carmakers to Task; Chrysler Must Reach Merger Deal with Fiat Within 30 Days as a Condition for New Aid*, The Gazette (Montreal), Mar. 31, 2009, at A3; Peter Whoriskey & Kendra Marr, *U.S. Plans Key Role in Naming GM Board; Government's Sway Over Firms It Aids Is Topic of Debate*, Wash. Post, Apr. 1, 2009, at A01. In addition, the government oversaw a massive reorganization of the financial sector, including brokering the merger of Bear Stearns with JP Morgan and the merger of Bank of America with Merrill Lynch, and overseeing management decisions at the bailed-out financial firms. *See* Binyamin Appelbaum, *Lewis Loses Chairman Role at Bank of America*, Wash. Post, Apr. 30, 2009, at A14; Binyamin Appelbaum, *Smoke Clears on Shotgun Merger; From the Details of BofA-Merrill Deal, Lawmakers Draw Arguments for Reform*, Wash. Post, June 12, 2009, at A14; Neil Irwin & David Cho, *Fed Takes Broad Action to Avert Financial Crisis; Central Bank Backs Sale of Bear Stearns, Cuts Key Interest Rate, Extends New Credit,* Wash. Post, Mar. 17, 2008, at A1; Joe Nocera, *Pay Cuts, but Little Headway in What Matters Most*, N.Y. Times, Oct. 23, 2009, at B1.

primacy on corporate governance matters. The reaction in Delaware to these unfolding federal initiatives has been consistent with the dynamic view of corporate federalism that this article advances.[78] Just as in the early 2000s, Delaware's corporate policymakers seemed to react to federal corporate governance activism by adjusting their approach on salient governance issues.[79]

A. The Battle Over Proxy Access

The most dramatic indication of Delaware's sensitivity to its precarious position vis-á-vis the federal government are recent statutory amendments to Delaware's corporate code that permit binding by-laws providing for proxy access.[80] In April 2009, Delaware's legislature adopted amendments to the Delaware General Corporation Law which permit corporations to adopt by-laws that give shareholders access to the corporate proxy statement for the purpose of nominating directors.[81] The new statutory provisions permit shareholder access but do not make it mandatory. The Delaware Bar's efforts to adopt optional shareholder access provisions appeared to be an attempt to get out in front of Congress and the SEC by allowing, as an option, reforms that would become mandatory if imposed by the SEC or Congress.[82] This attempt to forestall or temper federal regulation contrasts with the states' earlier initiative to thwart proxy access by embracing milder majority vote by-law proposals.[83]

1. The Federal Approach

The contemporary battle for proxy access began in 2003 when the SEC first proposed a new Rule 14a-11.[84] The proposed rule would have allowed significant shareholders to include their nominees for director in the corporate proxy statement in certain limited circumstances.[85] Despite its modest nature, the proxy proposal

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78. *See* Jones, *supra* note 22, at 644–46.

79. *Id*. Delaware has acted in a similar manner in the face of previous threats of federal corporate reform. *See* Roe, *supra* note 18, at 617–18, 643; Bratton & McCahery, *supra* note 16, at 685–90.

80. Del. Code Ann. tit. 8, § 112 (2009); *see also* Yin Wilczek, *Proxy Access Amendments to Del. Code signed into Law*, 41 Sec. Reg. & L. Rep. (BNA) 728 (Apr. 20, 2009).

81. § 112; Wilczek, *supra* note 80.

82. All amendments to Delaware's corporate statute are prepared and recommended by the council of the Corporation Law Section of the Delaware Bar Association. Typically, Delaware's legislature does little more than rubber stamp the committee's recommendations. *See* Renee M. Jones, *Legitimacy and Corporate Law: The Case for Regulatory Redundancy*, 86 Wash. U. L. Rev. 1273, 1288–90 (2009).

83. *See, e.g.*, E. Norman Veasey, *The Stockholder Franchise is Not a Myth: A Response to Professor Bebchuk*, 93 Va. L. Rev. 811, 813, 818 (2007) (suggesting that instead of mandatory proxy access, "we should concentrate on the majority voting movement and the newly realized power of stockholders to use precatory and binding bylaw proposals to good effect").

84. *See* 68 Fed. Reg. 60,784 to 60,789, 60,794 (Oct. 23, 2003) (to be codified at 17 C.F.R. pt. 200, 232, 240, 249).

85. *See id.* (providing under the proposed rule, that shareholders or groups holding 5% of voting securities for more than two years would be eligible to nominate a "short slate" of directors representing a minority

elicited fervent opposition from major business groups.[86] For example, the U.S. Chamber of Commerce threatened to sue the SEC if it adopted the rule as proposed.[87] The proposal languished at the Commission for more than a year as Chairman Donaldson was unable to forge a consensus among Commissioners. When Chairman Donaldson resigned after President Bush's re-election in 2004, the federal proxy access proposal appeared dead.

The proxy access battle was unexpectedly revived in the fall of 2006 when the U.S. Court of Appeals for the Second Circuit ruled in *AFSCME v. American International Group, Inc.*, rejecting the SEC's interpretation of Rule 14a-8.[88] Rule 14a-8(i)(8) allowed corporations to exclude shareholder proposals that "relate to an election of directors." In recent no-action letters, the SEC staff had concluded that corporations could exclude proposals to amend corporate by-laws to provide for proxy access even though such proposals sought only to establish procedures for future elections. This interpretation conflicted with the SEC's prior interpretation of the same rule.[89] The Second Circuit thus rejected the SEC's new position, deeming it arbitrary, and held that AIG was required to include the by-law proposal in its next proxy statement.[90]

The *AFSCME* decision presented a quandary for the SEC as it was binding only in the Second Circuit, creating the potential for conflict with rulings in other circuits.[91] Because of the potential for a circuit split, if the SEC did nothing, different standards for proxy access proposals might govern in different parts of the country. To resolve this conflict, the Commission revisited the question of proxy access in 2007. In an unusual move, the Commission released two competing proposals. The first proposal, the "access rule," would have allowed proxy access by-laws like the one at issue in *AFSCME*.[92] The "no-access" proposal released the same day codified the

of the board and that the right to submit nominations would accrue one year after a "triggering event" occurred which demonstrated shareholders dissatisfaction with the incumbent board).

86. *E.g.*, Press Release, U.S. Chamber of Commerce, U.S. Chamber Counters SEC Proposal: Changes to Voting Rules Bad for Shareholders, Companies (Dec. 19, 2003), *available at* http://www.uschamber.com/press/releases/2003.

87. Edward Iwata, *Chamber Threatens Suit on Board Nominating Plan*, USA Today, Mar. 11, 2004, at 3B.

88. 462 F.3d 121 (2d Cir. 2006). Rule 14a-8, the SEC's shareholder proposal rule, requires corporations to include proposals from shareholders in the corporate proxy statement distributed in connection with the annual meeting of shareholders. Corporations can exclude proposals deemed inappropriate under the rule. The SEC regularly releases "no-action" letters to advise shareholders and corporations on which proposals are excludable under Rule 14a-8. *Id.* at 123–25.

89. *Id.* at 128.

90. *Id.* at 123.

91. Lisa M. Fairfax, *Making the Corporation Safe for Shareholder Democracy*, 69 Ohio St. L.J. 53, 74–78 (2008).

92. Securities and Exchange Commission, Shareholder Proposals Relating to the Election of Directors, 72 Fed. Reg. 43,466, 43,469 (proposed July 27, 2007) (to be codified at 17 C.F.R. pt. 240).

SEC's pre-*AFSCME* position.[93] In December 2007, over objections from the democratic Commissioners, the SEC adopted the "no-access" rule.[94]

By 2009, the prospects for federal proxy access again appeared bright. New SEC Chair Mary Schapiro promised to revisit the issue and Congress embarked on financial reform legislation that would confirm the SEC's power to adopt proxy access rules, protecting the SEC from threatened legal challenges.[95] In June 2009, the SEC released a fourth proxy access proposal that included a new Rule 14a-11 similar to the 2003 version.[96] The SEC also proposed amending Rule 14a-8 yet again to permit shareholder access by-laws that went beyond the requirements of proposed Rule 14a-11.[97] In August 2010, after the Dodd-Frank Act conferred to the SEC authority to adopt rules regulating proxy access,[98] the SEC adopted a modified version of the 2009 proposals. New Rule 14a-11 gives individuals or groups representing at least 3% of voting power of a corporation the right to include nominees for up to 25% of board seats in the management proxy statement.[99] Rule 14a-8(i)(8) was amended to allow shareholders to propose by-laws that would supplement, but not abrogate, Rule 14a-11.

The new rules were scheduled to take effect in November 2010. In September 2010, however, the U.S. Chamber of Commerce and the Business Roundtable sued, challenging the legality of Rule 14a-11.[100] Among other claims, the Chamber alleged the SEC had not followed proper procedures when adopting the rule and failed to assess adequately its costs.[101] The SEC stayed implementation of its proxy access

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93. *Id.* at 43,488, 43,491.

94. 17 C.F.R. § 240, 14a-8 (2009).

95. Melissa Klein Aguilar, *Washington Brews With Looming Governance Reform*, Compliance Wk., May 5, 2009, *available at* http://www.complianceweek.com/article/5388/washington-brews-with-looming-governance-reform; *see* Wall Street Reform and Consumer Protection Act of 2009, H.R. 4173, 111th Cong. § 7222 (2009) (as passed by the House on December 11, 2009; Restoring American Financial Stability Act of 2010, S. 3217, 111th Cong. § 973 (2010)) (enacted).

96. *See* Securities and Exchange Commission, Facilitating Shareholder Director Nominations, 74 Fed. Reg. 29,024, 29,038 (proposed June 18, 2009) (to be codified at 17 C.F.R. pts. 200, 232, 240, 249, 274). Unlike the 2003 version of Rule 14a-11, under the 2009 proposal, proxy access would not be conditioned upon the occurrence of a "triggering event." In addition, the minimum ownership thresholds for submitting director nominations would be lowered from 5% to a range from 1% to 5% depending on a company's size, and qualified shareholders would be allowed to nominate directors for up to 25% of the board seats.

97. *See id.*

98. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 971, 124 Stat. 1376 (2010).

99. Securities and Exchange Commission, Facilitating Shareholder Director Nominations, 75 Fed. Reg. 56,668 (Sept. 16, 2010) (to be codified at 17 C.F.R. pts. 200, 232, 240, 249).

100. *See* Press Release, U.S. Chamber of Commerce, U.S. Chamber Joins Business Roundtable in Lawsuit Challenging Securities Exchange Commission (Sept. 29, 2010), *available at* http://www.uschamber.com/press/releases/2010/september/us-chamber-joins-business-roundtable-lawsuit-challenging-securities-an.

101. *See id.*

rules pending court proceedings.[102] Thus, the new rules will not take effect for the 2011 proxy season.[103] It remains to be seen how the court will rule, and how the SEC might respond to an adverse ruling, but it seems safe to assume that proxy access is an idea whose time will come . . . eventually.[104]

2. *Delaware's Evolving Stance on Proxy Access*

Delaware's evolving position on proxy access resembles a thrust and parry response to action at the federal level. When proxy access first appeared on the federal agenda in 2003, state bar officials acted forcefully to block it. Former Chief Justice Norman Veasey led this effort from his perch as the Chair of the American Bar Association's Corporate Law Committee.[105] In this position, Veasey promoted majority voting by-laws as an alternative to proxy access. Veasey argued that majority voting would obviate the need for proxy access by making a shareholder "withhold" vote more meaningful.[106] Under Veasey's leadership, the Model Business Corporation Act was amended to better facilitate majority voting by-laws.[107] The Delaware Bar's corporate law council shepherded through similar amendments to Delaware's General Corporation Law.[108]

Despite the apparent reprieve from federal regulation indicated by the demise of the SEC's 2003 proxy access proposal, Delaware's leaders remained wary of the threat posed by investors' sustained advocacy for proxy access. Some bar leaders and

102. In the Matter of the Motion of Business Roundtable and the Chamber of Commerce of the United States of America for Stay of Effect of Commissions Facilitating Shareholder Director Nomination Rules, No. S7-10-09 (Oct. 4, 2010), *available at* http://www.sec.gov/rules/other/2010/33-9149.pdf.

103. Yin Wilczek, *Briefing Schedule in Proxy Access Case Indicates New Rules Will Not Apply in 2011*, 42 Sec. Reg. & L. Rep. (BNA) 2018 (Oct. 25, 2010).

104. *Cf.* Martin Lipton & Steven A. Rosenblum, *Election Contests in the Company's Proxy: An Idea Whose Time Has Not Come*, 59 Bus. Law. 67 (2003) (arguing that within the context of new regulatory rules, "the adoption of proposals to facilitate election contests is an unwarranted step that offers little apparent benefit and threatens significant harm").

105. *See* Phyllis Diamond, *ABA Panel Weighing Possible Changes to Model Act on Voting for Directors*, 37 Sec. Reg. & L. Rep. (BNA) 476 (Mar. 14, 2005) (describing Veasey's efforts to advance majority voting as an alternative to the SEC's proxy access proposal); Rachel McTague, *Former Del. Supreme Court Chief Justice: Federal Power Threatens Role of Delaware Law*, 36 Sec. Reg. & L. Rep. 1493 (BNA) (Aug. 16, 2004).

106. *See* E. Norman Veasey, Remarks at the SEC Spotlight on Security Holder Director Nominations (March 4, 2004), *available at* http://www.sec.gov/spotlight/dir-nominations/transcript03102004.txt. Under a majority voting regime, directors who failed to receive the affirmative votes of a majority of shares voting at a meeting would be expected to resign their board seats.

107. *See generally* Comm. on Corporate Laws, ABA Section of Bus. Law, *Changes in the Model Business Corporation Act: Amendments to Chapter 7 and Related Provisions Relating to Shareholder Action Without a Meeting, Chapters 8 and 10 Relating to Shareholder Voting for the Election of Directors, and Chapter 13 Relating to Appraisal and Other Remedies for Fundamental Transactions*, 61 Bus. Law. 1427 (2006) (discussing, inter alia, changes to Model Business Corporation Act election provisions concerning plurality results and proxy votes).

108. Del. Code Ann. tit. 8, §§ 141(b), 216 (2009).

judges concluded it was better to join them than try to beat them.[109] The emerging view was that it was preferable to allow proxy access as an option at the state level than to face the risk of a federally imposed proxy access regime. The key distinction being that "no-access" would remain the default rule at the state level, while a federal rule would make proxy access mandatory under certain conditions.

The first clear sign of a shift in the state's approach on proxy access was the Delaware Supreme Court decision in *CA, Inc. v. AFSCME Employees Pension Plan*.[110] Ruling on a certified question from the SEC, the Delaware Supreme Court held that shareholder-proposed proxy access by-laws were permissible under state law, but that the specific shareholder by-law in question violated Delaware law.[111] Then, in April 2009, Delaware's legislature adopted amendments to the Delaware General Corporation Law which codified the Delaware Supreme Court's ruling in *CA, Inc*.[112] New section 112 of the Delaware General Corporation Law permits the adoption of by-laws that give shareholders access to the corporate proxy statement for the purpose of nominating directors.[113] The new provision allows for shareholder access but does not make it mandatory. Later, the Delaware Bar Association submitted a formal comment letter to the SEC criticizing the Commission's 2009 proxy access proposal.[114] This was the first time the Bar Association had ever commented on a proposed SEC rule.[115]

In summary, Delaware policymakers first responded to federal proxy access proposals by promoting majority voting by-laws as an alternative to proxy access. Despite states' acceptance of majority voting by-laws, shareholder activists continued

109. Leo E. Strine, Jr., *Breaking the Corporate Governance Logjam in Washington: Some Constructive Thoughts on a Responsible Path Forward*, 63 Bus. Law. 1079, 1094–98 (2008) (advocating for corporate acceptance of optional proxy access by-laws).

110. 953 A.2d 227 (Del. 2008).

111. *Id.* at 237, 240. At issue was a proposal by CA, Inc. shareholders to adopt a by-law mandating the reimbursement of expenses related to proxy contests if a shareholder slate received a minimum threshold of votes in a director election. *Id.* at 229–30; *see also*, Lisa M. Fairfax, *Delaware's New Proxy Access: Much Ado About Nothing?*, 11 Tenn. J. Bus. L. 87, 104–05 (2009).

112. *See* Fairfax, *supra* note 111, at 88.

113. § 112; Yin Wilczek, *Proxy Access Amendments to Del. Code Signed Into Law; Provisions Effective Aug. 1*, 41 Sec. Reg. & L. Rep. (BNA) 728 (Apr. 20, 2009). Delaware Bar Association's Council of the Corporation Law Section member, Lawrence Hamermesh reported that the amendments were prompted by Delaware's recent decision in *CA, Inc. v. AFSCME Emps. Pension Plan*. *See* Yin Wilczek, *Del. Legislature Mulling Proposals on Proxy Access; Law Likely to Pass*, 41 Sec. Reg. & L. Rep. (BNA) 528 (Mar. 23, 2009). Hamermesh stated that "[t]he decision was a primary catalyst for the proposed amendments, which go a long way to clarify what the impact of the court's decision was." *Id.*

114. Letter from James L. Holzman, Chair, Council of the Corp. L. Section, Del. Bar Ass'n to Elizabeth M. Murphy, Sec'y, U.S. Sec. & Exchange Comm'n 1, 2 (July 24, 2009), *available at* http://www.sec.gov/comments/s7-10-09/s71009-65.pdf ("[A] single rule would unnecessarily deprive Delaware corporations of the flexibility state law confers to deal effectively with myriad different circumstances that legislators and rulemakers cannot anticipate, and would thereby undermine a key element of the state system of corporate governance that has been largely successful for decades."); *see also* Fairfax, *supra* note 111, at 107–08.

115. Letter from James L. Holzman, *supra* note 114.

to press for proxy access by submitting binding shareholder access by-law proposals under SEC Rule 14a-8. Proxy access returned to the federal agenda in 2007—and again in 2009—prompting policymakers in Delaware to go further. In a first nod to proxy access, the Delaware Supreme Court ruled on a certified question from the SEC that proxy access by-laws were permissible under state law (although the by-law in question was not consistent with state law).[116] The Delaware Bar and legislature quickly embraced the ruling and worked to amend the statute to codify it.[117] The Delaware Bar Association then took the unprecedented step of formally urging the SEC not to adopt a mandatory shareholder access rule.[118]

B. *Executive Compensation*

In the area of executive compensation, the interplay between state and federal policy has been less direct. In the banking arena, new federal standards on executive compensation preempt state law to a significant extent. Through the Troubled Asset Relief Program (TARP) restrictions and pay czar oversight, the federal government oversees pay practices at all firms receiving government support. Furthermore, corporate governance provisions included in the Dodd-Frank Act ensure continued federal oversight of pay practices for financial firms and non-financial firms alike. Despite pending federal financial reforms, Delaware courts have continued to hew to the defendant-friendly interpretation of "good faith" adopted in *Disney IV* and *Stone v. Ritter*. The court's ruling in *In re Citigroup Derivative Litigation*, however, portends a possible relaxation of the formidable waste doctrine.[119]

1. *Federal Developments*

When Congress adopted the Economic Stabilization Act of 2008,[120] more popularly known as TARP, our government embarked on an unprecedented program of equity investment in the nation's most significant financial institutions. Initially, TARP contained relatively modest compensation provisions which required the Treasury Department to set guidelines for compensation for companies receiving TARP funds.[121]

In February 2009, President Obama announced new Treasury Guidelines on Executive Compensation for TARP recipients (the "Treasury Guidelines").[122] The new

116. CA, Inc. v. AFSCME Emps. Pension Plan, 953 A.2d 227, 237, 240 (Del. 2008).

117. *See* Wilczek, *supra* note 113.

118. Letter from James L. Holzman, *supra* note 114.

119. *See infra* text accompanying notes 148–54.

120. Emergency Economic Stabilization Act of 2008, H.R. 1424, 110th Cong. (2008).

121. *Id.* § 111. Under TARP, Treasury was required to prohibit parachute payments, claw back bonuses based on cooked earnings and place "limits on compensation that exclude incentives for senior executive officers . . . to take unnecessary and excessive risks that threaten the value of the financial institution." *Id.*

122. Press Release, U.S. Dep't of the Treasury, Treasury Announces New Restrictions On Executive Compensation (Feb. 4, 2009), *available at* http://www.treasury.gov/press/releases/tg15.htm [hereinafter Press Release].

restraints applied prospectively to recipients of future TARP payments. These compensation restrictions were fairly narrow, as they applied only to firms receiving "exceptional assistance" and affected only the five most highly compensated executives of the firms.[123] Salary for the top five executives was capped at $500,000 per year,[124] and bonus payments to senior executives were limited to restricted stock awards that recipients had to hold until their firms' TARP funds were fully repaid.[125] The Treasury Guidelines also required TARP recipients to allow shareholders an advisory vote on executive compensation packages ("Say on Pay") at future shareholder meetings.[126]

In February 2009, Senator Christopher Dodd sponsored an amendment to the economic stimulus bill which expanded TARP's compensation restrictions.[127] The "Dodd Amendment" limited bonus payments to executives at TARP recipients to one-third of their annual compensation.[128] The depth of the pay restrictions varied with the amount of TARP funds received. For recipients of $500 million or more in TARP funds, the limits applied to at least the twenty most highly paid executives.[129] Like the Treasury Guidelines, the Dodd Amendment allows bonus payments made in restricted stock and requires a shareholder Say on Pay on executive compensation.[130] In June 2009, the Treasury Department appointed Kenneth R. Feinberg as a special master, or "pay czar," to oversee the pay practices of bailed out firms.[131] In a number of high-profile rulings, Feinberg reset compensation packages for executives of companies that retained TARP funds.[132]

123. *Id.*; American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, § 7001, 123 Stat. 115, 516–17 (2009) ("The term 'senior executive officer' means an individual who is 1 of the top 5 most highly paid executives of a public company . . . .").

124. Press Release, *supra* note 122.

125. *See id*.

126. "Say on Pay" is shorthand for a policy requiring corporations to submit executive compensation policies to shareholders for a non-binding, advisory vote when soliciting proxies for the annual meeting. *See* Press Release, U.S. Dep't of the Treasury, FACT SHEET: Administration's Regulatory Reform Agenda Moves Forward: Say-on-Pay (July 16, 2009), *available at* http://www.ustreas.gov/press/releases/tg219.htm (outlining Say on Pay requirements in draft legislation delivered to Congress).

127. The stimulus bill is formally known as the American Recovery and Reinvestment Act of 2009. American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, 123 Stat. 115 (2009); 155 Cong. Rec. S1609-10 (daily ed. Feb. 4, 2009) (text of Sen. Christopher Dodd amendment); *see infra* note 128.

128. A summary of the Treasury Guidelines and the Dodd Amendment provisions is provided in Michael B. Dorff, *Confident Uncertainty, Excessive Compensation & the Obama Plan*, 85 Ind. L.J. 491, 529–52 (2010); *see also* Michael Maiello, *Yes—You Deserve a Fat Bonus*, Forbes, Mar. 16, 2009, at 28.

129. *See* Dorff, *supra* note 128, at 546–47.

130. *Id.*

131. Stephen Labaton, *Treasury to Set Executives' Pay at 7 Ailing Firms*, N.Y. Times, June 11, 2009, at A1.

132. *See* Jim Puzzanghera, *Corporate Salaries; Pay Czar Slashes Top Executives' Compensation at Five Firms*, L.A. Times, Mar. 24, 2010, at B1; Frank Ahrens & David Cho, *Pay Czar, Federal Reserve Crack Down on Executive Pay*, Miami Herald, Oct. 23, 2009, *available at* http://www.miamiherald.com/2009/10/23/v-print/1296044/pay-czar-federal-reserve-crack.html; Hibah Yousuf, *No 2009 Pay for Bank of America CEO Ken Lewis*, CNNMoney.com, Oct. 23 2009, http://www.money.cnn.com/2009/10/15/news/companies/bofa_lewis_salary/index.htm?section=money_news_newsmakers.

The executive pay restrictions imposed by TARP were merely the tip of the iceberg for federal corporate governance reforms related to executive pay. The Dodd-Frank Act provides for sustained federal oversight of corporate pay practices. Dodd-Frank imposes comprehensive federal oversight of financial firms deemed to pose a systemic risk to the economy.[133]

The Act creates a new Financial Stability Oversight Council, composed of the principal federal financial regulators to oversee prudential management for systemically significant firms.[134] In addition, section 956 of Dodd-Frank requires financial regulators to adopt rules that prohibit compensation structures that encourage inappropriate risks, by providing excessive compensation or that could lead to a material financial loss.[135]

Dodd-Frank's impact goes beyond oversight of financial institutions. Several provisions targeted at executive compensation apply to all public companies. For example, the Act mandates enhanced compensation disclosure, including a requirement that firms disclose the ratio between median compensation for all employees of a firm and the compensation for that firm's CEO.[136] It also requires a shareholder Say on Pay on executive compensation and golden parachutes,[137] and reforms the structure and practices of board compensation committees.[138] The Act also mandates stock exchanges to adopt rules requiring listed companies to maintain "claw back" policies for recovering incentive pay based on false financial reports.[139]

In sum, through TARP, "pay czar" oversight, and Dodd-Frank's governance provisions, the federal government has seized the issue of executive compensation and thereby marginalized Delaware law. Such broad federal engagement on pay-related issues significantly diminishes the appeal to management of Delaware's laissez faire approach on the matter. After all, the deference Delaware assures

133. Memorandum from Steptoe & Johnson LLP to The Nat'l Ass'n. of Ins. and Financial Advisors (Mar. 26, 2009), *available at* http://www.naifa.org/advocacy/documents/NAIFAHFSCGeithnerHearing.pdf.

134. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. Law No. 111-203, §§ 111-175, 124 Stat. 1376 (July 21, 2010).

135. *Id.* § 956. Even before Dodd-Frank was enacted, the Federal Reserve Board of Governors released proposed guidance on pay structures at financial firms. *See* Proposed Guidance on Sound Incentive Compensation Policies, 74 Fed. Reg. 55,227, (Oct. 27, 2009); *see generally* Ahrens & Cho, *supra* note 132 (discussing Federal Reserve Chairman Ben Bernanke's statements regarding proposed guidance for firms' long-term financial health).

136. Dodd-Frank Wall Street Reform and Consumer Protection Act § 953.

137. *Id.* § 951. Section 951 requires a shareholder advisory vote on executive compensation at least once every three years, and an advisory vote on golden parachute payments to be made in connection with mergers that are otherwise subject to shareholder approval. *Id.*

138. *Id.* § 952. Section 952 requires that compensation committees be comprised solely of independent directors and that committees have sole authority to hire consultants and counsel and determine their compensation, and requires corporations to disclose whether they employed compensation consultants and any potential conflicts of interest created by such engagements. *Id.*

139. *Id.* § 954.

directors on compensation questions will be of little comfort to corporate managers mired in compliance requirements imposed by the new federal statute.

2. *The Delaware Approach*

So far, the Delaware courts' response to these federal governance initiatives has been muted. Unlike in 2002, there have been few broad pronouncements from jurists denouncing federal legislation to reform financial regulation. Nor have there been discernible shifts in the tone or outcome of corporate law cases.[140] Instead, in *Lyondell* and *Citigroup* courts have stood firm in reiterating *Stone*'s holding and refusing to impose liability on directors for poor decisions or extreme passivity.[141]

Two of the more interesting corporate law cases decided in the aftermath of the financial crisis are *In re American International Group Consolidated Derivative Litigation* (*AIG*)[142] and *In re Citigroup Derivative Litigation*.[143] In *AIG*, the Delaware Court of Chancery allowed a complaint against AIG directors and officers for complicity in a financial fraud to survive a motion to dismiss.[144] The fact that the plaintiffs' claims were allowed to move forward in *AIG* does not tell us too much about the post-crisis approach to corporate governance. First, the conduct that was the subject of plaintiffs' allegations preceded the financial crisis and concerned the conduct of Hank Greenberg, the former CEO who had been replaced long before the events that precipitated AIG's 2008 collapse.[145] Furthermore, the plaintiffs had alleged that the defendant directors and officers were engaged in an expansive financial fraud, indeed, perhaps a criminal conspiracy.[146] Given the substance of the allegations, the fact that AIG itself had joined the plaintiffs on some claims, and the fact that AIG's special litigation committee took no position with respect to the other claims, it is not surprising that plaintiffs' claims survived the motion to dismiss.[147]

The outcome of *In re Citigroup Derivative Litigation* was less orthodox. Although some commentators have heralded *Citigroup* as standing for the proposition that Delaware courts stood firm on fiduciary principles for directors despite the financial

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140. *Cf.* David Marcus, *Laster's Moment*, The Deal Mag., Apr. 2, 2010, *available at* http://www.thedeal.com/newsweekly/features/laster%27s-moment.php (suggesting an effort by Vice Chancellor Travis Laster to maintain Delaware's relevance despite federal financial reforms through direct engagement in shareholder disputes traditionally viewed as part of the federal regulatory realm).

141. *See supra* text accompanying notes 73–75; *infra* text accompanying notes 148–54.

142. 965 A.2d 763 (Del. Ch. 2009).

143. 964 A.2d 106 (Del. Ch. 2009).

144. 965 A.2d at 776.

145. *See id.* at 789.

146. *Id.* at 776.

147. *Id.* at 775–76.

crisis, the decision on the waste claim defies such sanguinity.[148] Although the Chancellor dismissed plaintiffs' claims against directors for failure to monitor financial risks, in an unusual move he allowed a waste claim against Citigroup's directors to move forward.[149]

Citigroup shareholders had objected to the corporation's severance agreement with departing Chairman and CEO Charles Prince.[150] Under the contract, Prince received $68 million, "including bonus, salary, and accumulated stockholdings," an office, administrative assistant, and a car and driver for up to five years.[151] In exchange, Prince promised not to disparage Citigroup and to refrain from competing with the firm or soliciting its clients or employees.[152] The severance agreement at issue in *Citigroup* was fairly standard fare for executives departing major U.S. corporations.[153] With little in the way of explanation, Chancellor Chandler found that based on the facts alleged in the complaint, "there is a reasonable doubt as to whether the letter agreement meets the admittedly stringent 'so one sided' standard or . . . awarded compensation that is beyond the 'outer limit' described by the Delaware Supreme Court."[154]

The standard for evaluating a waste claim in Delaware is whether there was "an exchange of corporate assets for consideration so disproportionately small as to lie beyond the range at which any reasonable person might be willing to trade."[155] Applying this vague standard, the Delaware courts acquiesced to the Disney board's actions in awarding $140 million in severance to pay Michael Ovitz for his nine months of disastrous service at the company.[156] Not only was the value of Ovitz's

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148. *See* Andrew W. Stern & Alex J. Kaplan, *Delaware Chancery Court Reaffirms the Business Judgment Rule's Protection Against Claims of Undue Risk Taking*, 12 Corp. Gov. Rpt. 72 (2009) (discussing the impact of *Citigroup* and *AIG* on business decisions that led to company losses).

149. *See* Michael J. Biles & Kimberly G. Davis, *Delaware Court Allows Claims Based on Executive Compensation to Go Forward*, Bus. L. Today, Oct. 19, 2009, at 22, *available at* http://www.abanet.org/buslaw/blt/2009-09-10/keepingcurrent-corpcomp.shtml.

150. *In re* Citigroup Derivative Litig., 964 A.2d 106, 111–12 (Del. Ch. 2009).

151. *Id.* at 138.

152. *Id.*

153. By comparison, former CEO Stanley O'Neal walked away from Merrill Lynch with a package valued at $162 million. *See* John Cassidy, *Subprime Suspect*, The New Yorker, Mar. 31, 2008, at 78. Carly Fiorina left Hewlett-Packard with a severance package worth up to $42 million. *Carly May Get $42 million*, CNNMoney.com, http://money.cnn.com/2005/02/12/news/newsmakers/fiorina_severance/index.htm (last visited Aug. 28, 2010). Former Home Depot chief received about $210 million in cash and options. Ylan Q. Mui, *Home Depot's CEO Resigns, And His Hefty Payout Raises Ire*, Wash. Post, Jan. 4, 2007, at D01. Angelo Mozilo received roughly $120 million after Countrywide was acquired by Bank of America. Gretchen Morgenson, *Panel to Review Payouts Given by Troubled Firms*, N.Y. Times, Mar. 7, 2008, at C3.

154. *Citigroup*, 964 A.2d at 138.

155. *Id.* (citing Brehm v. Eisner, 746 A.2d 244, 263 (Del. 2000)).

156. *Disney I*, 731 A.2d 342, 350, 364, 380 (Del. Ch. 1998), *aff'd*, *Brehm*, 746 A.2d at 244; *see also Disney III*, 907 A.2d 693, 758–60 (Del. Ch. 2005), *aff'd*, *Disney IV*, 906 A.2d 27 (Del. 2006).

severance package extraordinary, his contract was structured so that he stood to earn more the sooner he was fired by the company. Nonetheless, the court ruled that neither the compensation contract nor the decision to grant Ovitz "non-fault" termination represented a breach of fiduciary duty by Disney's directors.[157]

Outside of the political and economic context, it is difficult to grasp why the *Citigroup* complaint was judged to state a claim for waste when the *Disney* complaint did not (especially considering that the same judge reviewed both complaints). Prince's severance amount was only $68 million, some of which may have represented compensation he had already earned. In contrast, Disney had agreed to pay Ovitz compensation valued at $140 million for his ignoble nine-month tenure with the company. One possible explanation is that Delaware judges are more sensitive to how they are perceived to manage compensation issues than they were in the period that followed the *Disney* trial. Reminiscent of the 2003 *Disney II* ruling that allowed the plaintiffs' claims to go to trial, the Delaware judiciary seems determined to demonstrate that it takes compensation issues seriously and is capable of handling such claims effectively.

IV. CONCLUSION

It is still too early to assess the long-term impact of the financial crisis on the U.S. corporate governance regime. It is clear, however, that recent federal regulatory reforms threaten to reduce Delaware's relevance in corporate governance—more so than the modest reforms embraced in Sarbanes-Oxley. Federal and state developments on shareholder access and executive compensation suggest that Delaware policymakers are working to maintain the state's primacy in the traditional realm of corporate governance.

In this round, Delaware's Bar and legislature have acted more decisively than the courts. The proxy access reforms adopted in the spring of 2009 are the most direct indication of Delaware's sensitivity to federal reforms. The significance of the courts' rulings in *AIG*, *Citigroup*, and *Lyondell* is less clear. On one hand, in *Citigroup* and *Lyondell* judges continue to adhere to *Stone*'s positioning of *Caremark* claims as virtually unsustainable. Yet, in *Citigroup*, the court allowed what had long been an even more formidable claim of waste—to move forward. The Delaware Chancery Court's decision on the waste claim may turn out to be no more significant than the similar denial of a motion to dismiss in *Disney II*, in the sense that it is unlikely that plaintiffs will ultimately prevail. Yet, the move may have the impact of blunting public criticism of the Delaware courts' record for steadfastly protecting of directors from personal liability for their failures.

157. *See* discussion *supra* Part II.B.