

ENHANCED DUTIES TO REDUCE THE RISK OF PUBLIC COMPANIES FALLING VICTIM TO OPPORTUNISTIC RENT SEEKING BEHAVIOR

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Abstract: Recently, the employment compensation policies and decisions of Wall Street corporate boards have come under close scrutiny. More specifically, the willingness to approve company wide compensation plans that resulted in the paying out of billions of dollars in bonuses even in the face of deteriorating financial and economic conditions. If only these and other Wall Street firms had retained the bulk of these large annual bonuses over the last several years when the financial markets were noticeably in decline, perhaps the economic impact of the current financial crisis would have been less severe.

Because of their unique and critical nature, these board policies and decisions bring up an interesting issue regarding the laws of corporate governance. That is, should the courts require a public company's board, a board composed of a majority of independent and presumably disinterested members, to apply specific or enhanced duties when the board decides to approve policies or make decisions that on their face implicate opportunistic rent seeking behavior on the part of one or more corporate stakeholders?

Based on a value of centralized authority framework of analysis, it is recommended that enhanced duties be applied to board decisions which on their face implicate opportunistic rent seeking behavior by one or more corporate stakeholders such as executive management, employees or shareholders.

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I. Introduction

Under corporate law, the board of directors is the ultimate decision making authority¹ in a public company.² This point is often ignored because so many board decisions are correctly delegated to executive officers and those other officers and managers in the chain of command that possess the expertise and informational advantages to make superior decisions on behalf of the organization.³

Yet, even with its authority to delegate,⁴ the board of a public company is still responsible for many major decisions,⁵ such as decisions involving employee compensation. Nothing highlighted this point more than the long running *Disney* litigation.⁶ In *Disney*, the Disney board approved an employment agreement with Michael Ovitz (President of Disney) which provided him with an unusually large severance payout if he were to be terminated without cause soon after commencing employment. Fourteen months after becoming employed, Ovitz was terminated without cause, leaving the company with a severance payout of approximately \$130 million.⁷

While the Orvitz employment agreement involved very significant compensation decisions for the Walt Disney Co., those decisions paled in importance compared to the ones made by the corporate boards of Wall Street's largest public companies prior to and

¹ Delaware General Corporation Law section 141(a) provides that "[t]he business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation." DEL. CODE ANN. tit. 8, § 141(a) (2001).

² A publicly held firm (public company) is an economic organization "in which (i) management and residual claimant status (shareholding) are separable and separated functions; (ii) the residual claims (shares) are held by a number of persons; and (iii) the residual claims are freely transferable and neither entry to nor exit from the firm is restricted." Michael P. Dooley, *Two Models of Corporate Governance*, 47 BUS. LAW. 461, 467 (1992).

³ Eisenberg, *Corporate Governance: The Board of Directors and Internal Control*, 19 Cardozo L. Rev. 237 (1997) (noting how the limited amount of time spent by directors on company business, six to twelve meetings per year, plus a typical lack of specific experience in the company business, does not make it possible for directors to manage a large public company).

⁴ Section 142(a) of the Delaware General Corporate Code provides that "Every corporation organized under this chapter shall have such officers with such titles and duties as shall be stated in the bylaws or in a resolution of the board of directors which is not inconsistent with the bylaws...." DEL. CODE ANN. tit. 8, § 142 (a) (2001).

⁵ Eisenberg, *supra* note 3, at 239 (Even if the board is primarily involved in monitoring, "the board also has important decisionmaking functions.").

⁶ *Brehm v. Eisner (In re Walt Disney Co. Derivative Litig.)*, 906 A.2d 27 (Del. 2006).

⁷ *Id.*

during the financial crisis of 2008, such as, the decisions to approve company wide compensation plans that resulted in the paying out of billions of dollars in bonuses even in the face of deteriorating financial and economic conditions. These decisions resulted in employees at the top five Wall Street firms, Goldman Sachs, Merrill Lynch, Morgan Stanley, Lehman Brothers and Bear Stearns, being paid in total a record \$39 billion in bonuses in 2007,⁸ up from \$36 billion in 2006.⁹ Moreover and somewhat remarkably, in 2008, a year in which Lehman Brothers went bankrupt, Merrill Lynch and Bear Stearns had to find merger partners because of extreme financial difficulty, Wall Street firms combined to lose tens of billions of dollars, and billions of taxpayer dollars went to bailout Wall Street firms; the New York Comptroller reported that Wall Street firms still paid out at least \$18.4 billion in employee bonuses.¹⁰ Most blatant was the decision of Merrill Lynch to release \$3.6 billion in board-approved bonuses on December 29, 2008 to a large number of Merrill Lynch employees just prior to the closing of the company's merger with Bank of America and shortly after it was known that Bank of America was requesting \$20 billion in extra bailout funds from the federal government in response to huge losses at Merrill Lynch.¹¹ If only these and other Wall Street firms had retained the bulk of these large annual bonuses over the last several years when the mortgage markets were noticeably in decline, perhaps the economic impact of the current financial crisis would have been less severe.

At first glance, it is hard to understand what the boards of directors of these Wall Street firms were thinking when they made these decisions. In hindsight, these decisions were detrimental to shareholders and were not consistent with a shareholder maximization norm.¹² Nevertheless, as discussed in detail below, these compensation

⁸ Tom Randall and Jamie McGee, *Wall Street Executives Made \$3 Billion Before Crisis* (Update1; September 26, 2008), available at <http://www.bloomberg.com/apps/news?pid=20601109&sid=aGL516xOPEHc&refer=exclusive>.

⁹ Christine Harper, *Wall Street Bonuses Hit Record \$39 Billion for 2007* (Update3; January 17, 2008), available at <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aHPBhz66H9eo>.

¹⁰ Ben White, *What Red Ink? Wall Street Paid Hefty Bonuses*, *The New York Times* (January 28, 2009), available at <http://www.nytimes.com/2009/01/29/business/29bonus.html?hp>. See also Heather Landy, *Wall Street Bonuses Draw Scrutiny in Bailout's Wake*, *The Washington Post*, Business Section 1 (January 24, 2009).

¹¹ Greg Farrell, *Lynched at Merrill*, *FT.com Financial Times* (January 25, 2009), available at <http://www.ft.com/cms/s/7de9ad20-eb05-11dd-bb6e-0000779fd2ac...> Six hundred and ninety six employees got bonuses of \$1 million or more. Karen Freifeld, *Merrill Bonus Recipients May Be Named in Week*, *N.Y. Judge Says*, *Bloomberg.com* (March 13, 2009).

¹² Also referred to as shareholder primacy, this model of corporate governance takes the "perspective that . . . directors of public corporations ought to be accountable only to the shareholders, and ought to be accountable only for maximizing the value of the shareholders'

policy decisions can be explained as being quite rational when put into the context of a team production approach to corporate law.¹³ In sum, in order to retain the services of traders and investment bankers, critical team members who could easily move their firm-specific investments to other firms, the boards of these firms yielded to their monetary demands, even though their firms were facing a deteriorating financial and economic environment.

However, these decisions may have been sub-optimal if traders and investment bankers had been engaged in “opportunistic rent seeking behavior.”¹⁴ This alleged behavior is believed to have occurred because compensation policies based on large annual bonuses encouraged traders and investment bankers to pursue what Professor Raghuram Rajan of the University of Chicago Business School refers to as “fake alpha” (appearing to create excess returns but in fact taking on hidden tail risks, which produce a steady positive return most of the time as compensation for a rare, very negative, return).¹⁵ In essence, the pursuers of fake alpha trade tail risk for cash, and hope that things don’t blow up until after huge bonuses have been paid out for a number of years.¹⁶

By investing in fake alpha, Wall Street firms are not earning excess returns above what the market will offer for the risk taken (“real alpha”), only normal returns with an unusual risk-return profile.¹⁷ The result is a misleading appearance of profitability and leads to an under-capitalized institution if compensation policies are not adjusted accordingly.¹⁸ Unadjusted compensation policies treat the annual returns earned for pursuing fake alpha as essentially risk-free when compensating investment bankers and traders, while the risks of loss are shifted to those who hold other interests in the

shares.” Margaret M. Blair & Lynn A. Stout, *Corporate Accountability: Director Accountability and the Mediating Role of the Corporate Board*, 79 WASH. U. L.Q. 403, 404 (2001).

¹³ Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247 (1999) (this is the seminal work on team production and corporate law).

¹⁴ Bernard S. Sharfman, Steven J. Toll, and Alan Szydlowski, *Wall Street’s Corporate Governance Crisis*, 17 CORP. GOV. ADV. 5 (2009). Rent seeking “refers to situations where individuals expend time, money, and other resources competing for a fixed amount of wealth, in effect squabbling with each other over the size of their individual pieces of a fixed group pie. Because rent seeking itself is costly, the net result is to reduce total wealth available for distribution.” Blair & Stout, *supra* note 13, at n. 4.

¹⁵ Raghuram Rajan, *Bankers’ pay is deeply flawed*, Financial Times FT.com (January 9 2008), available at http://www.ft.com/cms/s/18895dea-be06-11dc-8bc9-00779fd2ac.dwp_uuid=73adc504-2...

¹⁶ Sharfman, Toll and Szydlowski, *supra* note 14, at 5.

¹⁷ *Id.* at 5.

¹⁸ *Id.*

company (such as shareholders and ordinary employees, and now the US taxpayers) even though the costs of risk-taking may not be felt by these stakeholders for a number of years.¹⁹ Unfortunately, pay up time has now arrived and it is clear that the large bonuses given out in 2006, 2007 and 2008, if not also in prior years, were not warranted and contributed significantly to the ongoing financial crisis.²⁰

Perhaps the fall of American International Group, Inc. (“AIG”) serves as a classic example of how this can occur. As the story goes, AIG’s Financial Products unit had initially figured out a way to make real alpha by providing credit default swaps (an agreement between two parties pursuant to which the seller promises the buyer a payment in the event a bond or a loan defaults) on corporate bonds.²¹ But the unit could not stop at generating real alpha for a relatively small book of business; they ultimately began providing credit default swaps on more volatile forms of debt such as mortgage backed securities.²² This new business ultimately led to the firm’s demise.

But before the tail risk involved in the unit’s business was exposed, the unit produced outstanding results and the unit’s employees were rewarded accordingly. The unit’s revenue rose from \$737 million in 1999 to \$3.26 billion in 2005.²³ Operating income at the unit rose from 4.2 percent of A.I.G.’s overall operating income in 1999 to 17.5 percent in 2005.²⁴ During this time, the approximately 400 employees of the unit were provided lavish compensation.²⁵ Since 2001, compensation at the small unit ranged from \$423 million to \$616 million each year, making the average compensation of each employee of the unit more than \$1 million per year.²⁶

Even if Wall Street boards were duped by corporate employees pursuing fake alpha, these compensation decisions were rational and cannot be considered corporate waste. Therefore, they would still come under the protections of the business judgment rule (BJR).²⁷ But because of their unique and critical nature, they bring up an interesting

¹⁹ *Id.* at 5-6.

²⁰ *Id.* at 6.

²¹ Brady Dennis and Robert O’Harrow, *A Crack in the System*, The Washington Post 1, December 30, 2008.

²² *Id.*

²³ Gretchen Morgenson, *Behind Insurer’s Crisis, Blind Eye to a Web of Risk*, The New York Times, Business Section (September 27, 2008).

²⁴ *Id.*

²⁵ *Id.*

²⁶ *Id.*

²⁷ See *infra*, text to notes ___ to ___.

issue regarding the laws of corporate governance. That is, should the courts require a public company's board, a board composed of a majority of independent²⁸ and presumably disinterested members, to apply specific or enhanced duties in the process of deciding to approve policies or make decisions that on their face potentially implicate opportunistic rent seeking behavior on the part of one or more company stakeholders? Such board decisions include moving massive amounts of cash out of the company and into the pockets of one or more stakeholders (huge company wide bonuses, large executive management team compensation, large dividend payouts, aggressive stock buybacks, etc)?

Obviously, board decisions to transfer massive amounts of funds from the corporation to one or more stakeholders are not the only type of board decisions that on their face implicate opportunistic rent seeking behavior. Another example is the Enron board that gave its approval for executive management to establish and operate the now infamous LJM private equity funds, even though executive management had clear conflicts of interest in these transactions.²⁹ These types of decisions should also be considered eligible for enhanced duties.

The issue presented is analyzed utilizing the same value of centralized authority framework that this author presented in a prior article, *The Enduring Legacy of Smith v. Van Gorkom*.³⁰ Such a framework of analysis understands that the real value of the corporate form is its hierarchical nature as reflected in the centralized authority of the corporate board.³¹ This authority provides unique organizational efficiencies to a public company.³² These efficiencies are manifested by the corporate board's ability to (1) efficiently filter information in its decision-making process³³ and (2) act as a mediating

²⁸ For a public company to be listed on a major stock exchange, a majority of its board members must minimum exchange requirements for independence. For example, the New York Stock Exchange requires a public company's board to have a majority of independent directors and that the major corporate board committees—audit, compensation and nominating—be composed entirely of independent members. See NYSE, Inc., Listed Company Manual, §§ 303A.02–303A.06 (2006).

²⁹ Bernard S. Sharfman and Steven J. Toll, *Dysfunctional Deference and Board Composition: Lessons from Enron*, 103 NW. U. L. REV. COLLOQUY 153, 155-56 (2008), <http://www.law.northwestern.edu/lawreview/colloquy/2008/38/> (link).

³⁰ Bernard S. Sharfman, *The Enduring Legacy of Smith v. Van Gorkom*, 33 DEL. J. CORP. L. 287 (2008).

³¹ *Id.*

³² *Id.*

³³ *Id.* See *infra*, text to notes __ to __.

hierarchy.³⁴ Such organizational efficiencies create a strong presumption that the laws of corporate governance should not interfere with the corporate board's decision-making process.³⁵ However, even within this framework, this paper proposes that enhanced duties be applied to board decisions which on their face implicate opportunistic rent seeking behavior by one or more corporate stakeholders such as executive management, employees or shareholders. As discussed below, these enhanced duties have their own unique standard of conduct and review.

The analytical approach taken in this paper is meant for general application in all jurisdictions that have their own corporations' law or the equivalent, both domestically and internationally. However, the discussion that follows has been pragmatically framed in the context of Delaware corporate law, the state where the majority of the largest U.S. companies are incorporated.³⁶ Moreover, Delaware corporate law often serves as the authority that other U.S. states look to when developing their own statutory and case law.³⁷ Therefore, the examples are from Delaware, but the thinking is meant to be global in nature.

Part II of the paper describes how a team production understanding of corporate law provides a rational explanation for the making of Wall Street compensation decisions; Part III identifies types of decisions that on their face implicate opportunistic rent seeking behavior; Part IV discusses the value of centralized authority; Part V discusses the value of accountability; Part VI provides new enhanced duties and a standard of review for decisions that on their face implicate opportunistic rent seeking behavior; and Part VII concludes with a general overview.

II. Rationality, Team Production and Corporate Waste

As is well known, the BJR is a common law rule used by the courts to both minimize shareholder interference in board decision making and protect board members from financial liability. Delaware courts apply the following BJR formulation:

[The BJR] is a presumption that in making a business decision the directors of a corporation acted on an *informed* basis, in good faith and in the honest belief that the action taken was in the best interests of the company. Absent an abuse of discretion, that judgment will be respected by the courts. The

³⁴ *Id.* See *infra*, text to notes __ to __.

³⁵ *Id.*

³⁶ According to the State of Delaware web site, Delaware claims to be the legal home to more than 50% of all U.S. publicly-traded companies and 60% of the Fortune 500. See www.delaware.gov.

³⁷ Nadelle Grossman, *Director Compliance with Elusive Fiduciary Duties in a Climate of Corporate Governance Reform*, 12 Fordham J. Corp. & Fin. L. 393, 397 (2007).

burden is on the party challenging the decision to establish facts rebutting the presumption.³⁸

The BJR protects a corporate board decision from judicial review if four conditions are met.³⁹ First, the board must make a decision.⁴⁰ A decision not to act meets this requirement.⁴¹ Second, the board must have engaged in a process to become adequately informed of all material information reasonably available to make its decision.⁴² Third, the board must have made its decision in good faith.⁴³ Fourth, the decision must have been made by disinterested directors of the board.⁴⁴

But even if the decision is protected by the BJR, it must not result in corporate waste. According to the Delaware Supreme Court in the much publicized *Disney* litigation:⁴⁵

To recover on a claim of corporate waste, the plaintiffs must shoulder the burden of proving that the exchange was "so one sided that no business person of ordinary, sound judgment could conclude that the corporation has received adequate consideration." A claim of waste will arise only in the rare, "unconscionable case where directors irrationally squander or give away corporate assets." This onerous standard for waste is a corollary of the proposition that where business judgment presumptions are applicable, the board's decision will be upheld unless it cannot be "attributed to any rational business purpose."⁴⁶

³⁸Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) (citations omitted) (emphasis added).

³⁹Melvin Aron Eisenberg, *The Divergence of Standards of Conduct and Standards of Review in Corporate Law*, 62 FORDHAM L. REV. 437, 441 (1993).

⁴⁰*Id.*

⁴¹*Id.*

⁴²*Id.*

⁴³Eisenberg, *supra* note 3, at 441.

⁴⁴*Id.*

⁴⁵ Brehm v. Eisner (*In re* Walt Disney Co. Derivative Litig.), 906 A.2d 27, 121-22. (citations omitted) (Del. 2006). In *Disney*, the Delaware Supreme Court applied this standard when it rejected plaintiffs' arguments that the board committed corporate waste when it approved the contractually agreed to non-fault termination (NFT) payment to Michael Ovitz (President of Disney) upon his termination. *Id.*

⁴⁶ *Id.*

It could be argued that the recent decisions of Wall Street boards to pay out billions of dollars in compensation to executives, traders and investment bankers, during a time when their respective firms were reporting reduced profitability and facing a deteriorating economic and financial environment, were irrational, resulting in corporate waste. If so, they cannot be protected by the BJR. However, a team production approach to corporate law would argue that the decisions of Wall Street firms were rational as they were made with a very important business purpose in mind.

A. A Team Production Approach to Corporate Law

In their seminal work on team production and corporate law, *A Team Production Theory of Corporate Law*,⁴⁷ Professors Margaret Blair and Lynn Stout argued that a public company needs to be understood as a team of members who make firm-specific investments in the corporation with the goal of producing goods and services as a team (team production),⁴⁸ with the board of directors serving as a "mediating hierarchy."⁴⁹ From this perspective, the interests in a public company are represented by a "joint welfare function of *all* the individuals who make firm-specific investments and agree to participate in the extracontractual, internal mediation process within the firm."⁵⁰

Team members are primarily made up of executives, rank-and-file employees and equity investors, but can also include researchers, creditors, the local community, marketers, and vendors who provide specialized products and services to the firm and shareholders, among others.⁵¹ Any person or entity that makes a firm-specific investment, but is "unable to protect those investments by direct contracting, personal trust, or reputation," is a member of the team.⁵² The result is "that no one team member is a 'principal' who enjoys a right of control over the team."⁵³

⁴⁷Blair & Stout, *supra* note 13, at 271-76.

⁴⁸ Team production refers to "a productive activity requires the combined investment and coordinated effort of two or more individuals or groups." *Id.* at 249. For the seminal work on team production as a theory of economic organization, see Armen A. Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777 (1972). According to Alchian and Demsetz, "[W]ith team production it is difficult, solely by observing total output, to either define or determine *each* individual's contribution to this output of the cooperating inputs. The output is yielded by a team, by definition, and it is not a *sum* of separable outputs of each of its members." *Id.* at 779.

⁴⁹Blair & Stout, *supra* note 13, at 271-76. The mediating hierarchy model of the firm does not work where the firm is subject to the control of one shareholder or a group of shareholders. Under those conditions, the lack of independence impedes the ability of directors to act as mediating hierarchs. *Id.* at 309.

⁵⁰*Id.*

⁵¹*Id.* at 271-76 & n.61.

⁵²Lynn LoPucki, *A Team Production Theory of Bankruptcy Reorganization*, 57 Vanderbilt Law Review 741, 749 (2004).

In team production, it is recognized that agency costs may be created by the tendency of team members to 1) shirk in their duties, that is, “fail to make optimum efforts to ensure a joint project’s success, instead free-riding on others’ efforts,”⁵⁴ and 2) opportunistically seek rents at the expense of other team members.⁵⁵ Such agency costs can destroy the ability of the team to stay together and, because of the complexity of team production, cannot be remedied by explicit contracting between team members.⁵⁶

Professors Blair and Stout see corporate law as a solution, if only a second best solution,⁵⁷ to the agency costs caused by team production. In this innovative stakeholder approach to understanding the public company,⁵⁸ the board of directors, composed primarily of outside members who are also independent of the firm, provides a unique mediating function. Not only does it have the final authority on hiring and firing corporate officers, approving corporate policy, recommending major transactions for shareholder approval, approving executive compensation packages and the like, but it also acts “as an internal ‘court of appeals’ to resolve disputes that may arise among the team members.”⁵⁹ In this role, board members are “mediating hierarchs whose job is to balance team members’ competing interests in a fashion that keeps everyone happy enough that the productive coalition stays together.”⁶⁰

Trust is a key to this arrangement. As so well said by Professor Lynn LoPucki:

⁵³Blair & Stout, *supra* note 13, at 277.

⁵⁴*Id.* at n. 3.

⁵⁵*Id.* at n. 4.

⁵⁶*Id.* at 250.

⁵⁷ That is, “the best outcome that can be achieved, given that some of the conditions necessary for a first-best solution are violated.” *Id.* at n. 6.

⁵⁸ The team production approach to corporate law is a particular type of stakeholder model. Henry Hansmann and Reiner Kraakman, *The End of History for Corporate Law*, 89 *Geo. L.J.* 439, 447 (January, 2001). Hansmann and Kraakman refer to this particular form of stakeholder model as a “‘fiduciary’” model of the corporation, in which the board of directors functions as a neutral coordinator of the contributions and returns of all stakeholders in the firm.” *Id.* This is in contrast to another type of stakeholder model which they describe as a “‘representative’” model of the corporation,” where “two or more stakeholder constituencies appoint representatives to the board of directors, which then elaborates policies that maximize the joint welfare of all stakeholders, subject to the bargaining leverage that each group brings to the boardroom table.” *Id.* at 448.

⁵⁹Blair & Stout, *supra* note 13, at 276-77.

⁶⁰*Id.* at 281.

Team members choose to trust the board in part because they cannot trust each other. Board members receive salaries and perks, and may own some small amount of stock. But corporate law restricts their right to enrich themselves at the expense of the corporation. Board members cannot usurp corporate opportunities or control decisions in which their own interests conflict with those of the corporation. They are not residual claimants under the team production contract. To put it most bluntly, directors can steal, but directors cannot steal much. Those are the conditions most conducive to the fulfillment of a trust obligation.⁶¹

As summarized by Professors Blair and Stout, “In essence, the mediating hierarchy solution requires team members to give up important rights (including property rights over the team’s joint output and over team inputs such as financial capital and firm-specific human capital) to [a] legal entity created by the act of incorporation.”⁶²

The practical implication of this approach for the board of a public company and the courts is very significant. Given that the board’s ability to act as a mediating hierarchy is a benefit to all its team members, it is not too strong to say that *the board has a duty to the corporation to act as a mediating hierarchy*.

B. Support for a Team Production Approach to Corporate Law

An alternative approach to understanding corporate law is to believe that it is structured to maximize shareholder wealth. Taking this perspective is to be in the mainstream of corporate law thinking. According to Professors Hansmann and Kraakman, “There is no longer any serious competitor to the view that corporate law should principally strive to increase long-term shareholder value.”⁶³ In this worldview of corporate law, shareholders indirectly sit on top of the corporate pyramid as corporate managers have an obligation to manage according to shareholder interests.⁶⁴ The economic rationale for utilizing this “shareholder primacy norm” is that this is the best way for our society to maximize “aggregate social welfare.”⁶⁵

Yet, logic, experience and our understanding of corporate law tells us that a shareholder primacy norm does not exist in corporate law. For example, if corporate law were based on a shareholder primacy norm, one should at least expect that the law would treat shareholders as owners of the corporation. However, this is not the case. Although

⁶¹ LoPucki, *supra* note 52, at 751.

⁶² *Id.* at 250.

⁶³ Hansmann and Kraakman, *supra* note 58.

⁶⁴ *Id.* 440-41.

⁶⁵ *Id.* at 441.

shareholders do own interests in the corporation by owning company stock, they do not have ownership of the corporate entity. For example, title to corporate assets is in the name of the corporation, not its shareholders.⁶⁶ Moreover, and perhaps most importantly, corporate assets are controlled by the corporation's board of directors, not its shareholders.⁶⁷ Without control, shareholders become merely the "recipient[s] of the wages of capital."⁶⁸

Furthermore, while shareholders do have potential claims to the residual profits of the corporation, it is the board of directors that decides if a dividend will be paid, and how much the dividend will be. Moreover, corporate law clearly does not require the corporate board to follow the commands of its shareholders.⁶⁹ Shareholders may ratify a board's action, but the board must first approve the action.⁷⁰ Even if shareholders pass a unanimous resolution requesting the board to act in some specific matter, the board has the legal right to ignore such a resolution.⁷¹

In addition, directors are not agents of shareholders in a legal sense.⁷² Directors do not owe duties of obedience to shareholders.⁷³ Moreover, courts will not necessarily identify to which specific stakeholders the fiduciary duties of directors are owed or they may say that the duties are owed to the corporation.⁷⁴ Again, this is more consistent with a team production approach to corporate law than one that applies a shareholder primacy norm.

⁶⁶Blair & Stout, *supra* note 13, at 269.

⁶⁷*Id.* at 260-61 ("If 'control' is the economically important feature of 'ownership,' then to build a theory of corporations on the premise that ownership (and, hence, control) lies with shareholders grossly mischaracterizes the legal realities of most public corporations.").

⁶⁸*Id.* at 265 n.32 (citing ADOLF A. BERLE, JR. & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 3 (1932)).

⁶⁹*Id.* at 291.

⁷⁰Dooley, *supra* note 2, at 468.

⁷¹Blair & Stout, *supra* note 13, at 291 ("American law in fact grants directors tremendous discretion to sacrifice shareholders' interests in favor of management, employees, and creditors, in deciding what is best for 'the firm.'").

⁷²*Id.* at 290.

⁷³*Id.*

⁷⁴D. Gordon Smith, *The Shareholder Primacy Norm*, 23 J. Corp. L. 277, 284 (Number 2, Winter 1998). Of course, shareholders will sometimes be named as the beneficiaries of fiduciary duties. For example, the *Van Gorkom* court found that the directors' breached their fiduciary duty of candor to shareholders by not disclosing all material information necessary to make an informed decision on the merger transaction. *Smith v. Van Gorkom*, 488 A.2d 858, 893 (Del. 1985).

Finally, it is clear that the courts that adjudicate corporate law cases do not focus on shareholder wealth as the rationale for their decisions, limiting it to unusual situations such as when *Revlon* duties are to be applied.⁷⁵ This is most obvious when courts use the BJR to squash shareholder actions from an alleged breach in directors' duty of care.⁷⁶ Moreover, dictum from the Delaware Supreme Court's opinion in *Revlon* is clear that the duty of the board *prior to* the decision to sell the company is the preservation of the corporation, not shareholder wealth maximization:

The Revlon board's authorization permitting management to negotiate a merger or buyout with a third party was a recognition that the company was for sale. The duty of the board had thus changed from the preservation of Revlon as a corporate entity to the maximization of the company's value at a sale for the stockholders' benefit.⁷⁷

This dictum is consistent with a team production approach to corporate law.

C. The Interests of Shareholders

The rationale for why shareholders would accept such an arrangement is that team members, including shareholders, "understand they would be far less likely to elicit the full cooperation and firm-specific investment of other members [for fear of shirking and rent-seeking] if they did not [all agree to] give up control rights" to a mediating hierarchy (the board of directors), which has the responsibility of allocating "duties and rewards."⁷⁸ Moreover, the team production theory of corporate law suggests that, "a legal rule requiring corporate directors to maximize shareholder wealth *ex post* might well have the perverse effect of reducing shareholder wealth over time by discouraging non-shareholder groups from making specific investments in corporations *ex ante*."⁷⁹

⁷⁵Margaret M. Blair & Lynn A. Stout, *Corporate Accountability: Director Accountability and the Mediating Role of the Corporate Board*, 79 WASH. U. L.Q. 403, 406 (2001).

⁷⁶Smith, *supra* note 74, at 279-280 and 285-286 (As stated by Professor Smith, "Outside the takeover context, however, application of the shareholder primacy norm to publicly traded corporations is muted by the business judgment rule.").

⁷⁷*Revlon, Inc. v. MacAndrews & Forbes Holding, Inc.*, 506 A.2d 173, 182 (Del. 1986).

⁷⁸Blair & Stout, *supra* note 13, at 277-78.

⁷⁹Lynn A. Stout, *Why We Should Stop Teaching Dodge v. Ford*, 3 VA. L. & BUS. REV. 163, 173-74 (2008).

D. The Adverse Effects on the Corporation from Too Much Bargaining Power Possessed by Certain Stakeholders

Corporate law, by promoting the ability of the corporate board of a public company to act as a mediating hierarchy, encourages the firm-specific investment of team members, making incorporation a desirable means for establishing the rights and remedies of a public company's team members. However, the ability to act as a mediating hierarchy is not a perfect solution to the agency costs associated with team production. As an institutional substitute for the use of explicit contracts, it is still a second best solution.⁸⁰ This is most evident when the board is dealing with stakeholders who are perceived to be critical to the firm's success but whose firm specific investment is easily transferrable to another firm. For example, a Wall Street firm that depends heavily for its profitability on a large number of traders and investment bankers whose compensation is based primarily on annual bonuses and who can easily move their human capital to other firms if they do not feel their compensation is adequate.

As described in the Introduction, these stakeholders may exhibit opportunistic rent seeking behavior and will create a severe challenge for a board in its role as a mediating hierarchy. Therefore, even when faced with a deteriorating economic and financial environment, and with the knowledge that allowing billions of dollars to exit their company coffers may harm the firm's financial health, a Wall Street board may succumb to the pressure and allow for a massive cash outflow in the form of bonuses to avoid mass defections and a breaking up of the team.

Such decisions may be extremely risky to the corporation's welfare, but they are not irrational. This is so because the decisions to pursue such policies satisfy a key business purpose in keeping the coalition intact by avoiding mass defections. As such, the decision cannot be considered corporate waste.

III. Identifying Decisions that on their Face Implicate Opportunistic Rent Seeking Behavior

As a mediating hierarchy, the board of a public company is always balancing the interests of its various stakeholders when it makes its decisions. It does so to minimize the desire of the company's stakeholders to participate in rent seeking behavior. However, that does not mean that certain stakeholders will not opportunistically try and do so. The request to move massive amounts of cash out of the corporation and into the pockets of one or more stakeholders is a virtual red flag that this may be occurring. For example, the lessons learned from the recent financial crisis has put into focus those decisions of a board that lead to large cash outflows to specific stakeholders but where the company does not receive any apparent consideration. Of course, these decisions may involve large amounts of bonus compensation as we have already discussed, but they also may involve extraordinary dividend payouts or large stock repurchases. On

⁸⁰ Blair & Stout, *supra* note 13, at 250.

their face, these decisions clearly implicate opportunistic rent seeking behavior on the part of one or more corporate stakeholders and deserve heightened scrutiny by the board.

This understanding is consistent with what Professors Blair and Stout tell us about team production and the public company. According to Blair and Stout:

The mediating hierarchy model consequently suggests that the public corporation can be viewed most usefully not as a nexus of implicit and explicit contracts, but as a nexus of firm-specific investments made by many and varied individuals who give up control over those resources to a decisionmaking process in hopes of sharing in the benefits that can flow from team production.⁸¹

The corporate board, as a mediating hierarchy, has been entrusted with various inputs by its stakeholders, including financial assets. Decisions allowing large cash outflows without compensation are tainted on their face because they remove significant financial inputs from the firm which may be critical to the proper functioning or viability of the organization, even if they are intended to keep the team together.

A. Executive Management's Conflicts of Interest and Opportunistic Rent Seeking Behavior: Lessons from Enron

Decisions associated with massive cash outflows are not the only type of board decisions that on their face potentially implicate opportunistic rent seeking behavior by certain stakeholders. Another example is the board decisions that helped contribute to the infamous failure of Enron.⁸² In 1999 and 2000, the Enron board approved waivers to the Company's code of conduct three times that allowed Enron's Chief Financial Officer (CFO), Andrew Fastow, to establish and operate the now infamous LJM private equity funds.⁸³ These funds were set up to acquire Enron assets with the purpose of reducing the size of the Company's balance sheet.⁸⁴ Such an arrangement provided Fastow with immense opportunities to engage in self-dealing transactions at the expense of Enron and its shareholders.⁸⁵ Unfortunately, that is exactly what happened.⁸⁶ Ken Lay, Enron's Chief Executive Officer (CEO) at the time the funds were created, was cognizant of the

⁸¹ *Id.* at 285.

⁸² Sharfman & Toll, *supra* note 29.

⁸³ *Id.*

⁸⁴ *Id.*

⁸⁵ *Id.*

⁸⁶ *Id.*

controversial nature of this arrangement, and therefore sought board ratification despite the fact that he had full authority to approve the waiver on his own.⁸⁷

1. Dysfunctional Deference

The scenario just described, a scenario that clearly implicates opportunistic rent seeking behavior on the part of executive management, should have led to long and intense board deliberations, yet very little in the way of deliberations were reported prior to board approval, evidencing an incredible and surprising deference to the recommendations of management.⁸⁸ Without deliberation, there is no opportunity for board members to share potentially valuable information they may individually have regarding the decision, making the board as a whole less informed.⁸⁹ When such extreme deference to insiders and executive management leads to a stifling of board deliberations, this author has previously referred to this phenomenon as dysfunctional deference.⁹⁰

2. Group Polarization

A board succumbing to dysfunctional deference is an extreme example of how executive management can take advantage of a public company's board of directors. In more general applications, behavioral scientists have been saying for years that small deliberative groups are prone to error in their decision making if these groups are made up of a majority of members who are similar *in position* prior to deliberations.⁹¹ When they are, such groups can fall victim to what is referred to as *group polarization*, the tendency of a small deliberative group with an initial tendency to move in a given direction to move to even more extreme positions in that direction following group deliberations.⁹² This problem is especially relevant for groups who are like-minded and

⁸⁷ *Id.*

⁸⁸ *Id.*

⁸⁹ *Id.*

⁹⁰ *Id.* (where the phrase “dysfunctional deference” was coined in the context of corporate governance).

⁹¹ No one in the legal community has done more to sound the alarm about the problems of small group decision making than Professor Cass Sunstein. *See e.g.*, Cass R. Sunstein, *Deliberative Trouble? Why Groups Go to Extremes*, 110 YALE L.J. 71, 74 (October 2000) and Cass R. Sunstein, *Group Judgments: Statistical Means, Deliberation, and Information Markets*, 80 N.Y.U.L. REV. 962 (June, 2005).

⁹² Cass R. Sunstein, *Deliberative Trouble? Why Groups Go to Extremes*, 110 YALE L.J. 71, 74 (October 2000). Professor Sunstein notes that the term *group polarization* is misleading as it can be mistakenly interpreted to mean that group members move toward opposite positions. *Id.* at 85.

possess a shared identity.⁹³ The corporate board of a public company with a majority of independent directors is no exception to this problem.

It is easy to see how corporate boards could become victims of group polarization. Insider board members and executive management in general will have a greater degree of knowledge and understanding regarding the true state of the company than the independent directors. This asymmetric distribution of information should be beneficial to board decision-making assuming board insiders honestly share information about the pros and cons of a prospective decision with the other board members during deliberations. Given this understanding, it is only rational for independent board members to enter board deliberations with the initial tendency to presume that the business judgments of insiders and executive management are correct, creating a group of like-minded people.⁹⁴ Moreover, this initial tendency may be supported by a significant number of independent board members who have a shared identity, such as members who are also current or former CEOs. These board members form a dominant “in-group”⁹⁵ whose positions may polarize in order to conform to what they believe is the typical position of the other in-group members.⁹⁶ Such a scenario promotes the dominant initial position in discussion, limiting the arguments pool and proceeds to an extreme as in-group members hear their peer group voice similar positions and become more confident in their beliefs.⁹⁷

The understanding of how a board can fall victim to dysfunctional deference and group polarization⁹⁸ leads to the conclusion that decisions involving executive

⁹³ Cass R. Sunstein & Reid Hastie, *Four Failures of Deliberating Groups 2* (John M. Olin Law & Economics Working Paper No. 401 (2d Series) and Public Law and Legal Theory Working Paper No. 215, Apr. 2008), *available at* <https://www.law.uchicago.edu/files/401.pdf> at 18 (like-minded) and 21 (shared identity).

⁹⁴ Sunstein, *supra* note 92, at 81.

⁹⁵ Sunstein and Hastie, *supra* note 93, at 21.

⁹⁶ *Id.*

⁹⁷ *Id.*

⁹⁸ In the context of approving employee wide compensation policies, it is not hard to see how group polarization may have affected board decision making at Wall Street firms. These firms were run by and employed the most financially and mathematically sophisticated people in the world who in turn produced incredibly large annual profits for the firm. In this regard, it must have been an extremely humbling experience to be on the board of a Wall Street firm through at least 2006. Ronald Alsop, *M.B.A. Track: Wall Street Warms to Finance Degree with Focus on Math*, *The Wall Street Journal Online* (November 14, 2006) and Frank Ahrens, *For Wall Street's Math Brains, Miscalculations: Complex Formulas Used by 'Quant' Funds Didn't Ad Up in Market Downturn*, *washingtonpost.com* (August 21, 2007). If, executive management were inclined to promote and recommend company compensation plans that were focused on large annual bonuses, then it may have been hard for Wall Street boards to say no.

management's conflicts of interest should also to be considered on their face to implicate opportunistic rent seeking behavior, suggesting enhanced scrutiny by a board of directors.

IV. The Value of Centralized Authority

The decisions identified above as implicating opportunistic rent seeking behavior of certain stakeholders are not meant to imply that such decisions will necessarily lead to director liability or that we want directors to avoid making them. Doing so would jeopardize the value of centralized authority that is so critical to the successful operation of the corporate form.

Why corporate law places so much emphasis on the value of board authority can best be explained in terms of the unique organizational efficiencies that the corporate form provides to a public company.⁹⁹ These efficiencies involve the hierarchical nature of the corporate form as reflected in the centralized authority of the corporate board. They are manifested by the ability of a public company's board to (1) efficiently filter information in its decision-making process¹⁰⁰ and (2) as already discussed, act as a

While the focus of this paper is not on the motivations of executive management, it is possible to argue that keeping the team together through lavish company wide compensation during deteriorating economic and financial conditions offers executive management a number of advantages. First, keeping the team together may be critical to what they perceive as the value they provide the firm. For example, what else could have explained the decision of John Thain, the former head of Merrill Lynch, to accelerate \$3.6 billion in board approved bonuses to a large number of Merrill Lynch employees just prior to the company's merger with Bank of America, even though he knew that his company was soon to publicly disclose huge fourth quarter 2008 losses? Karen Freifeld and David Miltenberg, *Cuomo Subpoenas Thain and Alphin Over Merrill Bonuses*, Bloomberg News (January 27, 2009), available at, <http://www.bloomberg.com/apps/news?pid=20670001&refer=&sid=asBPF7zQ2Jgg>. Moreover, in another example of trying to keep "his" team together, Thain was more than willing to radically reduce the combined headcount of the investment banking team, but mainly at the expense of the Bank of America employees. Greg Farrell, *Lynched at Merrill*, FT.com Financial Times (January 25, 2009), available at <http://www.ft.com/cms/s/7de9ad20-eb05-11dd-bb6e-0000779fd2ac...> Second, executive management may try to keep the team together to order to maintain their large compensation packages since company size is a major determinant of executive compensation. See Lucian Arye Bebchuk and Yaniv Grinstein, *Firm Expansion and CEO Pay* (August 2007). Harvard Law and Economics Discussion Paper No. 533; Johnson School Research Paper No. 27-06. Available at SSRN: <http://ssrn.com/abstract=838245>. Third, keeping the team together will help maintain the reputations of top management as capable corporate leaders of large financial organizations. Allowing for massive defections may have a negative impact on their reputations.

⁹⁹ Sharfman, *supra* note 30.

¹⁰⁰ *Id.* at 290. Understanding the value of centralized authority begins with an understanding of Professor Arrow's theory of organizational authority. KENNETH J. ARROW, *THE LIMITS OF ORGANIZATION* (W.W. Norton & Co. 1974), at 63 to 79. Arrow starts with the basic proposition that "authority is needed to achieve a coordination of the activities of the members of the organization." *Id.* at 68. But, more importantly, centralized authority enhances organizational efficiency. According to Arrow, efficiency is created in a large organization because "the

mediating hierarchy to minimize agency costs caused by team production. Such organizational efficiencies create a strong presumption that the laws of corporate governance should not interfere with the corporate board's decision-making process.¹⁰¹ Moreover, for these efficiencies to be beneficial to the organization they must dominant the terms of any hypothetical agreement that the courts believe exists between the corporation and its shareholders.

Furthermore, the value of centralized authority provides extra benefits to widely held public companies. According to Professor Dooley, the value of centralized authority to a corporation is magnified as the knowledge and interests of its members diverge. In a public company, information and interests differ between management and shareholders.¹⁰² Especially where there are a large number of shareholders, it is much more efficient for a centralized authority with an overwhelming information advantage, such as the board of directors, to make corporate decisions rather than shareholders.¹⁰³

A. Delaware Corporate Law and the Value of Centralized Authority

It is clear that Delaware corporate law reflects and promotes the value of centralized authority by not only providing managerial authority to a small centralized

centralization of decision-making serves to economize on the transmission and handling of information." *Id.* at 69.

For an organization to be successful in its decision making, its decisions must be based on adequate information and made in a timely manner. This requires the organization "to facilitate the flow of information to the greatest extent possible." *Id.* at 70. Such facilitation requires "the reduction of the volume of information while preserving as much of its value as possible." *Id.* Centralized authority allows for "superior efficiency" by minimizing the number of communication channels required in a large organization. *Id.*

Professor Dooley was the first to make the connection between the work of Kenneth Arrow and the structure of Delaware corporate law. *See Dooley, supra* note 2.

¹⁰¹ Sharfman, *supra* note 30, at 290. Such a presumption is reflected in the BJR. The BJR works primarily by precluding the courts from reviewing duty of care claims. When used for that purpose, it has been referred to by Professor Bainbridge as a "doctrine of abstention." Stephen M. Bainbridge, *The Business Judgment Rule as Abstention Doctrine*, 57 VAND. L. REV. 83, 87 (2004). Of course, the exception to this preclusionary approach is found in *Van Gorkom*.

¹⁰² Dooley, *supra* note 2, at 467. The value of centralized authority is not as great in general partnerships and closely-held corporations because the same persons perform both the managerial and risk-taking (investment) functions. Management and partners or shareholders are essentially one and the same. *Id.* at 466-67.

¹⁰³ *Id.* The value of such specialization of function is quite clear. The best managers can be selected without regard to their ability to finance the company. On the other end of the spectrum, the shareholder pool is greatly increased as shareholders are not required to bring decision-making expertise along with their equity capital. Frank H. Easterbrook & Daniel R. Fischel, *Close Corporations and Agency Costs*, 38 STAN. L. REV. 271, 301 (1986).

group of individuals, the board of directors, but also by making it very difficult for stockholders or the courts to second-guess board decisions through judicial creations such as the BJR.¹⁰⁴ As so well stated by the Delaware Supreme Court in *Zapata Corp. v. Maldonado*:¹⁰⁵

The "business judgment" rule is a judicial creation that presumes propriety, under certain circumstances, in a board's decision. Viewed defensively, it does not create authority. In this sense the "business judgment" rule is not relevant in corporate decision making until after a decision is made. It is generally used as a defense to an attack on the decision's soundness. The board's managerial decision making power, however, comes from § 141(a). The judicial creation and legislative grant are related because the "business judgment" rule evolved to give recognition and deference to directors' business expertise when exercising their managerial power under § 141(a).¹⁰⁶

Shifting corporate decisions, even those that can be defined as possibly being tainted with opportunistic rent seeking behavior, from the board room to the court room, means denying the public company the informational advantages the board has over its shareholders and its ability to act as a mediating hierarchy.

V. The Value of Accountability

The discussion thus far is also not meant to suggest that the corporate board of a public company should be allowed to wield its authority without any accountability. The corporate board needs to be held accountable for its decisions or else it may act irresponsibly with the "likelihood of unnecessary error."¹⁰⁷ Moreover, "unaccountable authority may be exercised opportunistically."¹⁰⁸ Therefore, it is legitimate to criticize such authority and put into place some sort of "corrective mechanism."¹⁰⁹

Nevertheless, the fear is that in the process of trying to correct errors resulting from irresponsible decisions, "the genuine values of authority" will be destroyed.¹¹⁰ Such "a sufficiently strict and *continuous* organ of responsibility can easily amount to a denial of

¹⁰⁴Dooley, *supra* note 2, at 467, 471.

¹⁰⁵430 A.2d 779 (Del. 1981).

¹⁰⁶*Id.* at 782 (citation omitted).

¹⁰⁷ARROW, *supra* note 100, at 73-74.

¹⁰⁸Bainbridge, *supra* note 101, at 107.

¹⁰⁹ARROW, *supra* note 100, at 75.

¹¹⁰*Id.*

authority."¹¹¹ Arrow suggests, "[I]f every decision of A is to be reviewed by B, then all we have really is a shift in the locus of authority from A to B and hence no solution to the original problem."¹¹²

This understanding of the value of centralized authority is consistent with the lessons learned from *Van Gorkom*.¹¹³ In *Van Gorkom*, the Delaware Supreme Court put teeth into the "informed" element of *Aronson's* BJR formulation¹¹⁴ by creating what appeared to be a broad but reasonable constraint on corporate board discretion in the decision making process.¹¹⁵ As it was perceived to apply to all board decisions in general, the decision backfired on the Court in a big way.¹¹⁶ Directors threatened to resign because of the perceived increase in liability and when shareholders had the opportunity to amend their charters with exculpation clauses¹¹⁷ so that directors could be relieved of liability for duty of care violations arising out of the *Van Gorkom* decision, they did not hesitate to do so.¹¹⁸ For example, Professor Lawrence Hamermesh reported that out of a sample of one hundred Fortune 500 companies, ninety-eight had adopted an exculpatory provision. Furthermore, each of the fifty-nine Delaware corporations in the

¹¹¹*Id.*

¹¹²*Id.*

¹¹³ *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985). For a detailed discussion of the negative effects of the decision, especially on the value of centralized authority, see Sharfman, *supra* note 16.

¹¹⁴ *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984).

¹¹⁵ 488 A.2d 858 (Del. 1985).

¹¹⁶ As is well known, the *Van Gorkom* decision has been criticized heavily. See e.g., Sharfman, *supra* note 16.

¹¹⁷ Under DEL. CODE ANN. tit. 8, § 102(b)(7) (2001), shareholders are allowed to incorporate into their certificate of incorporation:

A provision 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, provided that such provision shall not eliminate or limit the liability of a director: (i) For any breach of the director's duty of loyalty to the corporation or its stockholders; (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law; (iii) under § 174 of this title; or (iv) for any transaction from which the director derived an improper personal benefit

Id.

¹¹⁸ Lawrence A. Hamermesh, *Why I Do Not Teach Van Gorkom*, 34 GA. L. REV. 477, 497-503 app. A (2000).

sample had such a provision in their corporate charters.¹¹⁹ Thus, in order for a corrective mechanism to be of value to the organization, it must be applied intermittently.¹²⁰

The denial of authority, and thus the value of centralized authority, is truly the issue when evaluating whether or not the courts should require a board to engage in enhanced duties when making decisions that on their face implicate opportunistic rent seeking behavior. Yet, our recent financial crisis has revealed a significant flaw in corporate governance that needs to be addressed. It is not desirable to have Wall Street boards approving compensation policies or other types of cash outflows that can be detrimental to their firms because their roles as mediating hierarchies compels them to yield to the negotiating power of one specific type of stakeholder. It is also not desirable if group polarization or dysfunctional deference helps push directors in the direction of approving transactions that involve executive management. Accountability must have its place in this board room dilemma, but *only if* corporate law can adequately accommodate the value of centralized authority.

VI. Enhanced Duties for Decisions that Implicate Opportunistic Rent Seeking Behavior

Wall Street compensation policies have revealed a weakness in the ability of corporate boards to act as mediating hierarchies. Because corporate law created the ability of corporate boards to act as mediating hierarchies, we must first look to corporate law to see if it can provide a solution. Requiring enhanced or special duties by the board when it contemplates decisions that on their face implicate opportunistic rent seeking behavior is the proposed way to fix the problem. The result, as proposed below, is a small reduction in the authority of corporate boards under a relatively narrow fact pattern. However, it is still necessary that the efficiency gains from this increase in accountability actually exceed the efficiency loss from the corresponding decrease in board authority. If not, a change in corporate law will only make matters worse.

A. A Proposed Standard of Conduct

According to Professor Melvin Eisenberg, “a standard of conduct states how an actor should conduct a given activity or play a given role.”¹²¹ Enhanced duties are essentially the standard of conduct that is expected of the board when dealing with decisions that on their face implicate opportunistic rent seeking behavior. Therefore, the

¹¹⁹ *Id.*

¹²⁰ ARROW, *supra* note 100, at 78. According to Arrow, this intermittent application of accountability “[c]ould be periodic; it could take the form of what is termed “management by exception,” in which authority and its decisions are reviewed only when performance is sufficiently degraded from expectations; or it could take the form of review and deeper study of a random sample of decisions or periods.” *Id.*

¹²¹ Eisenberg, *supra* note 39, at 437.

following new conduct should be required of all public company boards when dealing with decisions that on their face implicate opportunistic rent seeking behavior:

In the process of making decisions that on their face implicate opportunistic rent seeking behavior (huge company wide bonuses, large executive management team compensation, large dividend payouts, aggressive stock buybacks, etc), the public company's board must consider how the implementation of such decisions would affect the company's liquidity position, its capital adequacy, its funding risk and its credit rating, etc. If after such informed deliberations, a majority of the independent and disinterested board members of a public company's board believes it is in the best interests of the corporate to go ahead with such decisions, then it is not up to the courts to say otherwise.

The proposed enhanced duties find their origin in existing law. They are analogous to *Revlon* duties (duties that require a board "when it undertakes a sale of the company, to set its singular focus on seeking and attaining the highest value reasonably available to the stockholder."¹²²) as they are not to be thought of as "unique fiduciary obligations," but as court guidance on how a public company's board should fulfill its duties of care and loyalty in the context of decisions that implicate opportunistic rent seeking behavior of one or more stakeholders.¹²³

This proposed conduct of the board when dealing with decisions that implicate opportunistic rent seeking behavior is to be considered part of a board's risk management duties. Such duties cannot be delegated to executive management, only the board is in position to make them. In essence, if a public company's board adequately considers potentially tainted decisions in the context of their effect on the financial health and viability of the firm and still decides to go ahead with these decisions, then the board has acted responsibly as the corporation's mediating hierarchy and as the decision making body that is in the best position in terms of information and expertise to make such decisions.

B. A Standard of Review for the Proposed Enhanced Duties

According to Professor Eisenberg, "a standard of review states the test a court should apply when it reviews an actor's conduct to determine whether to impose liability or grant injunctive relief."¹²⁴ Under corporate law, it is necessary to have standards of review that diverge from standards of conduct because corporate actors necessarily make

¹²² 2008 Del. Ch. LEXIS 105, *8 *citing* *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986).

¹²³ *Ryan v. Lyondell Chemical Company*, 2008 Del. Ch. LEXIS 105, *51 (Del. Ch., July 29, 2008).

¹²⁴ *Id.*

decisions in a world of imperfect information; corporate actors take on roles, such as board members, where the outcomes of their decisions may have negative outcomes that far outweigh the potential rewards for taking on such roles; and there is a need for corporate stakeholders to respect the value of corporate authority, right or wrong.¹²⁵ *Van Gorkom*'s gross negligence standard of review for being informed when making a business decision is a classic example of where the standard of review diverged from the standard of conduct.¹²⁶

1. Good Faith and the Standard of Review

The development of a standard of review moves the analysis from the conceptual to the pragmatic. Before a standard of review can even be developed, a tool of accountability needs to be identified. For better or worse, "good faith" is the only tool of accountability that is realistically available to the Delaware courts. This is so for two basic reasons. First, exculpation clauses under Delaware Code Section 102(b)(7) have become so prevalent that it has made it very difficult to pursue duty of care liability claims under *Van Gorkom*.¹²⁷ Second, because we are dealing with a board that is presumably independent and disinterested, claims that the directors have breached their duty of loyalty as a result of conflicts of interest or self-dealing cannot be made. That leaves good faith as the tool of accountability for enforcing the proposed enhanced duties.

Good faith as a tool of accountability is currently in the same position that duty of care was just prior to *Van Gorkom*. At that time, a duty of care under Delaware law had long been recognized,¹²⁸ the Chancery Court had recognized that a duty to be informed was a required precondition to directors receiving the protections of the BJR¹²⁹ and that gross negligence, though undefined as to whether it applied to substantive or procedural due care, could lead to director liability.¹³⁰ Yet, prior to *Van Gorkom*, no one really knew the liability implications of not being informed. Good faith now lies in that same realm of uncertainty. Even though *Stone v. Ritter*¹³¹ has incorporated good faith into the duty of loyalty and it is now understood that the determination of a good faith breach revolves

¹²⁵ *Id.* at 437-38.

¹²⁶ *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985).

¹²⁷ See *supra*, text to notes 123-124.

¹²⁸ *Graham v. Allis Chalmers*, 188 A.2d 125 (Del. 1963).

¹²⁹ *Kaplan v. Centex Corp.*, 284 A.2d 119 (Del. Ch. 1971).

¹³⁰ *Penn Mart Realty Co. V. Becker*, 298 A.2d 349, 351 (Del. Ch. 1972).

¹³¹ *Stone v. Ritter*, 911 A.2d. 362 (Del. 2006).

around the “conscious disregard of duties,”¹³² it has not been resolved where the zone of liability lies in the context of board decision making.

However, that is also fortunate as it allows more flexibility when proposing where that zone of liability should lie.¹³³ For example, we need not repeat the mistakes of *Van Gorkom* and craft a new standard of review that must apply to all board decisions in general. As explained by Arrow, a “continuous organ of responsibility can easily amount to a denial of authority.”¹³⁴ That is, if a board is not willing to make decisions because of the potential for incurring liability, who is to take its place? Therefore, board accountability must be applied intermittently so as not to deny the board its rightful authority to make corporate decisions.¹³⁵

Arrow’s point of intermittent application is very important to the proposed use of good faith. This paper is not suggesting that good faith have a general application, only that it be applied when the proposed enhanced duties or other enhanced duties of an independent and disinterested board, such as Revlon duties, are required. This approach can be considered an application of good faith by exception. This way, corporate law can avoid a repeat of the events that followed *Van Gorkom*.

2. A Caremark Approach to Good Faith

Guidance on how to develop a good faith standard of review for the proposed enhanced duties that is consistent with the value of centralized authority can be found in Chancellor Allen’s famous opinion in *Caremark*.¹³⁶ In *Caremark*, the Chancellor, by identifying a new affirmative duty to monitor corporate compliance with “applicable legal standards” whether or not the board has been given notice of any wrongdoing on the

¹³² Andrew C.W. Lund, *Opting Out of Good Faith* (March 9, 2009), available at SSRN: <http://ssrn.com/abstract=1356127>.

¹³³ Professor Lund suggests a liberally construed application of the conscious disregard standard in conjunction with the ability of a corporation to exculpate directors for such liability, similar to what done under DEL. CODE ANN. tit. 8, § 102(b)(7) 102(b)(7). *Id.* However, such an approach would certainly compel the vast majority of public companies to incorporate such an exculpation clause into their charter because of the significant increase in potential director liability, thereby wiping out the ability of good faith to be used as a tool of accountability. The result is a repeat of *Van Gorkom* with another tool of accountability lost. *Id.*

¹³⁴ ARROW, *supra* note 100, at 78.

¹³⁵ *Id.* at 78. According to Arrow, this intermittent application of accountability “[c]ould be periodic; it could take the form of what is termed “management by exception,” in which authority and its decisions are reviewed only when performance is sufficiently degraded from expectations; or it could take the form of review and deeper study of a random sample of decisions or periods.” *Id.*

¹³⁶ 698 A.2d 959 (Del. Ch. 1996).

part of the company's employees, unexpectedly took it upon himself to overrule a Delaware Supreme Court case that had stood for 33 years, *Graham v. Allis Chalmers*:¹³⁷

[A] director's obligation includes a duty to attempt in good faith to assure that a corporate information and reporting system, which the board concludes is adequate, exists, and that failure to do so under some circumstances may, in theory at least, render a director liable for losses caused by non-compliance with applicable legal standards.¹³⁸

Clearly, even in his description of this new duty, he was already signaling that the standard of review needed to be quite lenient, and so it was:

[O]nly a sustained or systematic failure of the board to exercise oversight -- such as an utter failure to attempt to assure a reasonable information and reporting system exists -- will establish the lack of good faith that is a necessary condition to liability.¹³⁹

On one hand, Chancellor Allen wanted a board to be more actively involved in company oversight and monitoring,¹⁴⁰ but on the other hand by creating a good faith standard of review that made it extremely difficult to find director liability; he was directing the law away from the mistakes of *Van Gorkom*:¹⁴¹

Such a test of liability -- lack of good faith as evidenced by sustained or systematic failure of a director to exercise reasonable oversight -- is quite high. But, a demanding test of liability in the oversight context is probably beneficial to corporate shareholders as a class, as it is in the board decision context, since it makes board service by qualified persons more likely, while continuing to act as a stimulus to good faith performance of duty by such directors.¹⁴²

What is so amazing about this standard of review was the meaning the Chancellor gave to a lack of good faith. In essence, plaintiffs would have to show that the board abdicated its oversight duties in order for the court to find director liability. Yet, this

¹³⁷ 188 A.2d 125 (Del. 1963).

¹³⁸ 698 A.2d 959 at 970 (Del. Ch. 1996).

¹³⁹ *Id.* at 971.

¹⁴⁰ Jennifer Arlen, *The Story of Allis-Chalmers, Caremark, and Stone: Directors' Evolving Duty to Monitor*, Law & Economics Research Paper Series, Working Paper No. 08-57 at 3 (November 2008), available at <http://ssrn.com/abstract=1304272>.

¹⁴¹ 698 A.2d 959 at 971 (Del. Ch. 1996).

¹⁴² *Id.*

approach was accepted by the Delaware Supreme Court in *Stone v. Ritter*.¹⁴³ Chancellor Allen demonstrated that in a standard of review analysis, definitions of legal terms such as good faith are not created based on etymology, but on what is needed to meet the needs of the legal doctrine being developed.

3. Applying a *Caremark* Approach to Decisions that on their Face Implicate Opportunistic Rent Seeking Behavior

Clearly, there is a wide gap between duties associated with decisions that on their face implicate opportunistic rent seeking behavior and the duties associated with a board's oversight function. Duties associated with potentially tainted decisions necessarily need to be reviewed each time such a decision is made, rather than over a period of time where it can be determined that a "sustained and systematic impairment" of oversight has occurred. Still, Chancellor Allen's approach to a standard of review for board oversight, in essence an abdication approach for identifying a breach of good faith, can be applied to proposed duties required for decisions that implicate opportunistic rent seeking behavior. In actuality, it may be the only approach possible that allows for a clear distinction between a lack of due care and a lack of good faith so desired by the Delaware Supreme Court in *Disney*:

From a broad philosophical standpoint, that question is more complex than would appear, if only because (as the Chancellor and others have observed) "issues of good faith are (to a certain degree) inseparably and necessarily intertwined with the duties of care and loyalty. . . ." But, in the pragmatic, conduct-regulating legal realm which calls for more precise conceptual line drawing, the answer is that grossly negligent conduct, without more, does not and cannot constitute a breach of the fiduciary duty to act in good faith. The conduct that is the subject of due care may overlap with the conduct that comes within the rubric of good faith in a psychological sense, but from a legal standpoint those duties are and must remain quite distinct. Both our legislative history and our common law jurisprudence distinguish sharply between the duties to exercise due care and to act in good faith, and highly significant consequences flow from that distinction.¹⁴⁴

Abdication of duties can straddle either side of the fence, but because of exculpation clauses that cut off duty of care claims for an independent and disinterested board, it is pragmatically necessary to keep it on the side of a lack of good faith and thereby allow it to be utilized as a tool of accountability.¹⁴⁵

¹⁴³ *Stone v. Ritter*, 911 A.2d. 362 (Del. 2006).

¹⁴⁴ 906 A.2d 27, 94-95 (Del. 2006) (citations omitted).

¹⁴⁵ According to Professor Hillary Sale, "[a]n obvious or egregious violation, resulting from **abdication**, subversion, or deliberate indifference, however, calls good faith into play." Hillary A. Sale, *Delaware's Good Faith*, 89 CORNELL L. REV. 456, 488 (2004).

4. Lyondell Litigation

Decisions that on their face implicate opportunistic rent seeking behavior are still business decisions and therefore come under the BJR. Director liability for business decisions occurs when directors breach their duties of care and/or loyalty in the making of those decisions. The enhanced duties associated with potentially tainted decisions are not to be thought of as “unique fiduciary obligations,” but as court guidance on how a public company’s board should fulfill its duties of care and loyalty in the context of these decisions.¹⁴⁶ Thus, enhanced duties simply direct a court where to look when trying to identify breaches in fiduciary duties.

Simplifying the analysis is that it can be presumed that conflicts of interest and director self dealing will not be an issue when evaluating decisions that on their face implicate opportunistic rent seeking behavior as the board will be made up of a majority of independent and presumably disinterested directors. This is similar to the *Caremark* fact pattern where there were no allegations or evidence of such director behavior.¹⁴⁷ Moreover, while a *Van Gorkom* duty of care analysis cannot be avoided by the courts under the BJR, unlike Chancellor Allen who was not so bound in *Caremark* because he was dealing with oversight duties and not business decisions, the practical reality is that if a corporation has an exculpation clause in its charter, the *Van Gorkom* analysis will not lead to director liability.

a. Ryan v. Lyondell

Most fortunately, the recent litigation in *Ryan v. Lyondell*¹⁴⁸ provides a model for applying an abdication approach to decisions that on their face implicate opportunistic rent seeking behavior. In *Lyondell*, the Chancery court denied a motion for summary judgment because the record did not show any evidence that the board attempted to adequately perform its *Revlon* duties.¹⁴⁹

The critical point for the Court was that these were a known set of board duties requiring certain board conduct whose performance was not found in the record. Without such evidence on the record, the court felt the board may have violated its duty of good faith.¹⁵⁰ Because the board’s duty of good faith was in question, the defendants’ argument

¹⁴⁶ *Ryan v. Lyondell Chemical Company*, 2008 Del. Ch. LEXIS 105, *51 (Del. Ch., July 29, 2008).

¹⁴⁷ 698 A.2d 959 at 967 (Del. Ch. 1996).

¹⁴⁸ 2008 Del. Ch. LEXIS 105, * (Del. Ch., July 29, 2008).

¹⁴⁹ *Id.*

¹⁵⁰ *Id.*

that the corporation's exculpation clause would relieve them of liability and provide the legal basis for granting the motion for summary judgment did not apply.¹⁵¹ Therefore, the motion for summary judgment could not be granted and the litigation terminated.¹⁵²

The court cited for its authority *Stone v. Ritter*,¹⁵³ where the Delaware Supreme Court stated: "Where directors fail to act in the face of a known duty to act, thereby demonstrating a conscious disregard for their responsibilities, they breach their duty of loyalty by failing to discharge that fiduciary obligation in good faith."¹⁵⁴ This was a statement made in the context of board oversight where the board was accused of not having a system in place to monitor for violations of law.¹⁵⁵ However, this statement was derived from the dicta of *Disney*, a decidedly non-oversight case, where the Court said, "A failure to act in good faith may be shown, . . . where the fiduciary intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties."¹⁵⁶ By utilizing the statement from *Stone v. Ritter* as authority, the Chancery court was logically applying what it believed to be the Delaware Supreme Court's understanding of good faith duties in the context of both oversight and non-oversight fact patterns.

b. The Interlocutory Appeal

Upon interlocutory appeal, the Delaware Supreme Court reversed the decision and remanded the case back to the Chancery Court stating that defendants were entitled to summary judgment because they found no evidence from which to draw the conclusion that the directors knowingly ignored their responsibilities.¹⁵⁷ The Supreme Court agreed with the Chancery Court on the important point that "bad faith will be found if a 'fiduciary intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties,'"¹⁵⁸ but disagreed with what *Revlon* duties required and the standard of review applied by the trial court.

¹⁵¹ *Id.*

¹⁵² *Id.* at *87-*88.

¹⁵³ *Stone v. Ritter*, 911 A.2d 362 (Del. 2006).

¹⁵⁴ 2008 Del. Ch. LEXIS 105, *87 *citing* *Stone v. Ritter*, 911 A.2d at 370.

¹⁵⁵ 911 A.2d 362 (Del. 2006). In *Stone v. Ritter*, the Court affirmed the standard for director oversight liability first proposed in *In re Caremark*, "a sustained or systematic failure of the board to exercise oversight—such as an utter failure to attempt to assure a reasonable information and reporting system exists . . ." 698 A.2d 959, 971 (Del. Ch. 1996).

¹⁵⁶ 906 A.2d 27, 67 (Del. 2006).

¹⁵⁷ *Lyondell v. Ryan*, Delaware Supreme Court (March 25, 2009) at 3, available at [http://courts.delaware.gov/opinions/\(3ub1km55aepbvc55gfvzpn55\)/download.aspx?ID=119350](http://courts.delaware.gov/opinions/(3ub1km55aepbvc55gfvzpn55)/download.aspx?ID=119350).

¹⁵⁸ *Id.* at 18 quoting *Disney* at 67.

First, the Supreme Court noted that there is “only one Revlon duty” and that duty requires the board “to get the best price for the stockholders at a sale of the company.”¹⁵⁹ This means there are “no legally prescribed steps that directors must follow to satisfy their *Revlon* duties.”¹⁶⁰ Thus, “the directors’ failure to take any specific steps during the sale process could not have demonstrated a conscious disregard of their duties.”¹⁶¹ This approach is consistent with the approach taken with enhanced duties for decisions that on their face implicate opportunistic rent seeking behavior. There are no prescribed steps, only that the board of a public company consider the financial effects on the company from implementing these decisions.

Second, and most importantly, the Supreme Court applied a standard of review that is not only consistent with Chancellor Allen’s abdication approach in *Caremark*, but also with this paper’s value of centralized authority approach to board decisions:

Directors’ decisions must be reasonable, not perfect. In the transactional context, an extreme set of facts is required to sustain a disloyalty claim premised on the notion that disinterested directors were intentionally disregarding their duties. The trial court denied summary judgment because the Lyondell directors’ unexplained inaction prevented the court from determining that they had acted in good faith. But, if the directors failed to do all that they should have under the circumstances, they breached their duty of care. Only if they knowingly and completely failed to undertake their responsibilities would they breach their duty of loyalty. The trial court approached the record from the wrong perspective. Instead of questioning whether disinterested, independent directors did everything that they arguably should have done to obtain the best sale price, *the inquiry should have been whether those directors utterly failed to attempt to obtain the best sale price.*¹⁶²

Because of their critical importance to the survival and financial health of the firm, it is argued here that the duties associated with decisions that on their face implicate opportunistic rent seeking behavior should also be treated in the same manner as the Delaware Supreme Court treated the board’s *Revlon* duties in its review of *Ryan v. Lyondell*. In the case of decisions that on their face implicate opportunistic rent seeking behavior, the duties required are considering the financial effects on the company from implementing these decisions. Like *Revlon* duties, these duties are known, but

¹⁵⁹ *Id.* at 16.

¹⁶⁰ *Id.* at 18.

¹⁶¹ *Id.*

¹⁶² *Id.* at 18-19 (citations omitted).

unspecified, and if a court of inquiry finds that a board utterly failed to attempt to perform these duties, then director liability should follow. Moreover, abdication is meant to be a bright line, so as to minimize indeterminacy under the law, but is not meant to be overcome by a board created façade of compliance.

If a board is determined to have made a good faith attempt to fulfill the duties associated with decisions that on their face implicate opportunistic rent seeking behavior, then the review for director liability would come under *Van Gorkom* for a determination if the board was properly informed when it made its decision. If the company has an exculpation clause in its charter, then the board will be absolved of liability even if the facts show that the board had violated its duty of care. Such an approach fits neatly into Delaware's developing doctrine of good faith.

VII. Conclusion

In *Gagliardi v. TriFoods Intern., Inc.*, former Chancellor Allen stated that “[s]hareholders’ investment interests, across the full range of their diversifiable equity investments, will be maximized if corporate directors and managers honestly assess risk and reward and accept for the corporation the highest risk adjusted returns available that are above the firm’s cost of capital.”¹⁶³ Clearly, it is not desirable to cool a company’s rational pursuit of the “highest risk adjusted returns” it can potentially earn if that is the board’s goal and is consistent with its duties as a meditating hierarchy. But the decisions of Wall Street firms to voluntarily transfer huge amounts of capital to one specific stakeholder without compensation during uncertain financial and economic times has given us pause to consider whether or not a change in corporate law is necessary to support the ability of these boards to push back against the demands of stakeholders who are in unusually strong negotiating positions *vis-à-vis* the board and other stakeholders. The need for enhanced scrutiny is even more apparent when executive management is supporting the position of the strongly positioned stakeholder(s) and group polarization or dysfunctional deference is present. To deal with this issue, this paper proposes new enhanced duties for certain types of board decisions that on their face implicate opportunistic rent seeking behavior by corporate stakeholders. Corporate law can accommodate these enhanced duties through a good faith standard of review that is fact pattern specific and highly deferential to directors and therefore does not create a threat to the value of centralized authority.

¹⁶³ *Gagliardi v. Trifoods International, Inc.*, 683 A.2d 1049, 1052 (Del. Ch. 1996).

