The Role of the Judiciary in Corporate Law, Corporate Governance and Economic Goals

by

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Company Law Reform in OECD Countries
A Comparative Outlook of Current Trends

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I should begin with some boundaries on my presentation. I am not an expert on comparative company law or corporate governance systems outside the United States. What I hope I am competent to discuss are the realities of fiduciary duties of directors under United States corporation law as that law is exemplified by Delaware law. My thesis is that in a well-developed jurisprudential system of corporate governance—like that of Delaware—the dynamics of the daily functions of the board are governed by norms.

That is, non-legal rules and standards. These norms have been built up in a culture shaped by a history of fiduciary duty litigation in the environment of an enabling regime, as distinct from a mandatory or regulatory regime.

In the United States we have a federal system. In corporation and commercial law each of the states has its own statutes and courts to enforce and interpret these laws. The major exception to state-based governance in the corporate area is the federal regulation of securities which is due to the inherently interstate nature of the buying and selling of securities.

I will not explore here the issues involved in the federal regulation of securities. My focus here is on the law and culture governing internal affairs of corporations.

**Introduction**

An overarching global debate is whether corporation law should be mandatory or enabling. I agree with those scholars whose thesis is that the enabling model is the better economic model for the stockholders than an inflexible regulatory model. The enabling model, patterned after the Delaware approach, is based on a few fundamental statutory guideposts and judicial application of fiduciary duties to fact-intensive settings, with wide latitude for private ordering and reliance on self-governance.

A word of caution is that the judge-made law that is at the heart of the Delaware model must not be of a free-wheeling or ad hoc quality. It must involve a disciplined and stable


stare decisis analysis based on precedent and a coherent economic rationale. The private ordering aspect of it must be important to provide ex ante the contractual stockholder protections deemed important, as distinct from ex post judicial rewriting of the contractual construct. The self-governance aspect of this model is based on good faith development of, and adherence to, good corporate practices not mandated by law.

At the end of the day the enabling model—at least in Delaware—rests on a two-fold trust. That trust is placed in the Judiciary and in the board of directors. Moreover, it is predicated on two fundamental principles: the first is character—by that I mean expertise, diligence, good faith, independence and professionalism. The second is a sound economic rationale dedicated to the best interests of stockholders. I must emphasize that those character traits and decisional rationale apply both to the board of directors and to the courts that apply fiduciary duty doctrine in specific factual settings.

Investors, as the owners of corporations, have certain expectations of the role of courts in the enforcement of fiduciary duties. The judicial process is a key ingredient in the overall corporate transaction among the four parties involved—the stockholders, directors, management, and state government (legislative, executive, and judicial).

Courts should be:

Prompt
Clear
Reasonably predictable
Stable
Have a coherent economic rationale
Delaware Law Background

Three years ago Delaware celebrated the 100th anniversary of its current Constitution of 1897. That Constitution provided two major regimes that are relevant here. It authorized legislation creating a general corporation law and it revamped the judicial selection process. That judicial selection process, which has now been in effect for over a century, provides for twelve-year terms, appointment by the Governor (today from a merit-selected list recommended by a bipartisan commission) with confirmation by the Senate, and a bipartisan judiciary (both major political parties must be nearly equally represented in the courts of the state).

Shortly after the adoption of the 1897 Constitution, the Delaware legislature adopted a general corporation law that generally mirrored New Jersey’s. Many large national firms had incorporated in New Jersey. New Jersey, however, began to overregulate corporations in the early part of the twentieth century. As a result, a significant migration of corporate charters to Delaware occurred in the early 20th Century. The resulting litigation of disputes involving internal corporate affairs shaped Delaware history and the landscape of corporation law in the United States. From the early part of the Twentieth Century to today the Delaware Court of Chancery and Delaware Supreme Court built up extensive business expertise, a vast amount of rich case law, and international respect. Delaware now has about 300,000 corporations. Included are corporations comprising more than fifty percent of the Fortune 500 companies and nearly the same proportion of those listed on the New York Stock Exchange.

Models of Corporate Governance

Just as a “one size fits all” structure of internal governance and the management style of businesses is unrealistic, the same is true of company law and corporate governance systems from nation to nation. So, company law reform must take into account each
nation’s history, culture and economy. Since I am not an expert in the laws, cultures, and economies of the OECD countries, I will confine my remarks to relatively safe territory—little Delaware: tiny in size and population but radiating corporate influence well beyond its borders.

My own professional experience of about 43 years includes 34 years as a corporate law practitioner, counselor and litigator. For the past nearly 9 years I have had the honor to serve as the Chief Justice of Delaware. When I was a practicing lawyer, I served for several years on the board of directors of a major New York Stock Exchange Company.

This was in the 1980s when two major developments occurred in the United States and abroad: the takeover era and the sharpening of the analysis of fiduciary duty law and principles of corporate governance. These two developments were closely related, in my view.

What do we mean when we use the term, “corporate governance?” I have seen a number of definitions over the years since that term emerged into prominence in the United States during the 1980s. In its broadest sense it is used to define the structure, relationships, control mechanisms, and objectives of the corporate enterprise. The objectives of the firm are to attract capital, perform efficiently and profitably and to comply with the law for the benefit of stockholders. I would like to focus on what I call the “control mechanisms” that are extant under our enabling model.

As I see it, those control mechanisms break down into four categories—at least in Delaware:

The organic structure of the enabling statutory law

The judge-made fiduciary duty law as it applies to the conduct of directors

The norms of everyday functioning of the board and management

The aspirations to achieve best practices at the board level

In April 1998 the Business Sector Advisory Group made its report to the Organization for Economic Cooperation and Development (OECD). This report is generally known as the Millstein Report. The recommendations of that Report ripened into the OECD
Principles of Fairness, Transparency, Accountability and Responsibility.
Two of these Principles are relevant to my thesis today:

The corporate governance framework should protect shareholders’ rights
The corporate governance framework should ensure the strategic guidance of the company, the effective monitoring of management by the board, and the board’s accountability to the company and the shareholders

By focusing on these two Principles, I do not intend to denigrate the importance of the other principles, including:
Equitable treatment of all shareholders and the opportunity for redress of their rights
Timely and accurate disclosure of all material matters including financial information, performance, ownership and governance of the company

Our time today does not permit a comprehensive analysis of the complexities and nuances of all the concepts of the Millstein Report juxtaposed with Delaware law. But I will pause to illustrate one of those complexities.

The OECD Principle dealing with the board’s obligations to other “stakeholders,” may require extended analysis because, on the surface, there may be a fundamental inconsistency with Delaware law to this extent: The interests of stockholders are paramount under Delaware law, and those interests should not be equated with, or sublimated to, the interests of creditors, employees, suppliers or the community.

Although the interests of stakeholders other than stockholders may be considered by the board according to some Delaware caselaw dicta, it is clear under the holdings of Delaware judicial decisions that the interests of the stockholders is paramount.

Some state legislatures—decidedly not Delaware’s—have passed antitakeover statutes that permit directors to consider these other constituencies as a mechanism to rationalize conduct of directors in attempting to thwart a hostile takeover. Delaware’s regime concerning the latitude of directors in these circumstances rests on the primacy of stockholder interests.

In her book, The Genius of American Corporate Law, Professor Roberta Romano
analyzed the state takeover statute phenomenon and concluded that Delaware’s case-by-case approach is preferable for investors to those states having the strong “other constituency” antitakeover regime. The rationale for the Delaware protocol is simply that the singular focus on stockholder interests avoids diffusing the accountability of the board. Thus, Delaware does not give the board unfettered discretion that could be rationalized under the “other constituency” regime because almost any action could be justified or rationalized as being in the interest of one or more of these outside groups.

The goal of attracting investment capital should be a cardinal goal of the board. This goal is served if board action is focused primarily on long-term stockholder value. It is this economic rationale that courts must consider in adjudicating principles of fiduciary duty. That is why I strongly support the first of the OECD Principles: That the corporate governance framework should protect stockholder rights. That basic Principle, in turn, guides the Principle relating to the responsibilities of the board—their fiduciary accountability to the company and the stockholders.

These fiduciary duties in Delaware are fleshed out by judge-made law applied on a case-by-case basis within the framework of the enabling act. The remainder of the corporate governance regime consists of private ordering, norms and the aspirations of well-motivated directors to achieve best practices with the precatory encouragement of courts.

**Private Ordering**

One of the protections for investors is private ordering. The enabling act allows wide discretion to fine-tune many intra-corporate arrangements. The directors have the statutory responsibility to direct the management of the business and affairs of the corporation unless the certificate of incorporation otherwise provides.

Contractual arrangements *ex ante* through specially negotiated securities, stockholder protection devices, buyouts of minority stockholders, and the like are encouraged. *Ex post* “bailouts” by courts of minority stockholders who have not taken advantage of
private ordering opportunities are inappropriate.
The Roles of the Board

Let us focus on the various roles of the board. The board hires management—personified by the CEO—and management makes most of the “enterprise decisions”—(e.g. should the plant be in Stockholm or Liverpool?)

The board itself must make some basic decisions under the statutory framework (e.g. declaring a dividend). Often the board makes strategic planning decisions and some high level compensation decisions. These enterprise decisions are important, but they do not ordinarily involve judicial scrutiny. They usually affect the corporation’s wealth directly and the stockholders’ wealth indirectly. If there is litigation in this area, it is often derivative.

Enterprise decisions are to be distinguished from “ownership decisions.” Some of these decisions occur in corporate mid-life. Others come as part of the final period decisions (such as mergers). Ownership decisions usually affect stockholders’ interests directly. Stockholders benefit from a profitable company—one that can attract capital and one that has ever-expanding earnings and earning potential. Stockholders expect a board that is not risk-averse. They also want a board that knows the business, is smart, honest and hard-working. Probably and usually, they want a good percentage of the board to be independent. Do they want, however, a bureaucratic board of nit-picking independent directors that slow down the capital-attracting and profit-making decisions of expert management supported by knowledgeable directors? Of course not. Does it matter whether the directors are distracted by expensive nuisance litigation? Of course it does.

Do stockholders benefit from a board engaged in meaningful oversight? Director oversight of management is in the investors’ best interests. No doubt directors who have a habit of sustained inattention may create an atmosphere in which profit-making is static or stultified. Likewise “utter failure” to put in place some rational mechanism for monitoring law compliance could harm the corporation and might result in director liability.
As to business decisions, the business judgment rule has the effect of freeing directors and the CEO to take business risks. Thus, directors’ decisions will be respected by courts unless the directors are interested or lack independence relative to the decision, do not act in good faith, act in a manner that cannot be attributed to a rational business purpose or reach their decision by a grossly negligent process that includes the failure to consider all material facts reasonably available. Courts do not measure, weigh or quantify directors’ judgments.

We do not even decide if they are reasonable in this context. Due care in the decision making context is process due care only. Irrationality is the outer limit of the business judgment rule. Irrationality may be the functional equivalent of the waste test or it may tend to show that the decision is not made in good faith, which is a key ingredient of the business judgment rule.

It is also in the stockholders’ economic interest that courts enforce violations of the duty of loyalty. In such cases there may be severe damage awards against faithless fiduciary who act in their own self-interest not in the interest of the firm.

Similarly, defensive measures that are designed and implemented to advance the stockholders’ interests are tolerated by the courts. Poison pills, for example, are tolerated on the theory that they provide the board with leverage to benefit stockholders and to save them from the “prisoner’s dilemma” inherent in stock dispersal. Thus, it is often found to be a safe harbor for directors if they use the pill in a reasonable manner to stave off an inadequate offer.

But if they keep the pill in place to thwart a premium takeover, there may be cases where their defensive measures are not reasonably related to a threat to the corporation’s health and well being. One could argue the economics of this dynamic, and I believe there are empirical data to support the economic benefit to stockholders arising out of the reasonable use by the board of the pill of other defensive measures.

On the other hand, there are limits on directorial latitude. Is the device being used primarily for entrenchment of the incumbent board? Is it reasonable in relation to the
threat? Are there limits to when directors can “just say no?” Must they “just say no, because ...” (with a reasonable blank to be filled in)? These are judgment calls, but in these ownership decisions—many of which are final period decisions—there is more judicial oversight than there is in the “plain vanilla” business judgment rule.

Yet many stockholders would prefer that the directors not have in their arsenal poison pills and other defensive weapons. Their choice, it would seem, is that they would rather run the risk of the prisoner’s dilemma and thus to have the choice to accept or reject an offer for their stock than to trust the judgment of the board.

This is a debatable economic choice based on the available data. If stockholders are not successful in requiring the removal of the pill, they must rely on the courts to make judicial decisions with an economic rationale when the occasion presents itself.

Potential profit often corresponds to the potential risk. So, it is very much in the interest of stockholders that the law not create incentives for overly cautious corporate decisions. Some opportunities offer great profits at the risk of very substantial losses, while the alternatives offer less risk of loss but also less potential profit. A stockholder with a diversified portfolio is willing to invest in seemingly risky alternatives that may result in loss because the losses in some stocks will, over time, be offset by even greater gains in others. Stockholders’ 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 available risk-adjusted returns that are above the firm’s cost of capital.

But directors will tend to be risk-averse if they must assume some degree of personal risk relating to ex post claims of liability for any resulting corporate loss occasioned by the business decision going bad. They need not worry under our law for mistakes of judgment—even “stupid” ones. But a stockholder-plaintiff might be able to plead a grossly negligent process theory, survive a motion to dismiss, and then extract a settlement.
Due Care

Liability for lack of due care by directors is an often-analyzed—perhaps overanalyzed—subject. As noted, there is no liability for the substance of a bad business judgment reached in good faith, even if the decision was stupid by hindsight, unless, of course, the decision fails the waste test or the decision-making process was materially flawed. There is, to be sure, an exposure of boards, in making enterprise decisions, for fraud, disloyalty, law violation, bad faith and the like. There is also a theoretical exposure of directors to personal liability in damages for gross negligence in process due care that forfeits the protection of the business judgment rule. But, in reality, it may only be theoretical, because of statutory protection.

First, under one Delaware statute, 8 Del. C. § 141(e), directors are “fully protected in relying in good faith upon the records of the corporation and upon such information, opinions, reports or statements presented to the corporation by any of the corporation’s officers or employees, or committees of the board of directors, or by any other person as to matters the member reasonably believes are within such other person’s professional or expert competence and who has been selected with reasonable care by or on behalf of the corporation.”

Second, there is another statutory exemption (8 Del. C. § 102(b)(7)) which, when adopted in the corporate charter by stockholders, basically exempts directors from liability for negligence. In 1986 Delaware took the lead nationally in adopting this amendment to its general corporation law. Most state legislatures have since authorized, and stockholders of most corporations in Delaware and elsewhere, have exonerated directors for liability for duty of care violations, but preserved liability exposure for more serious wrongdoing. These provisions are generally worded so that they eliminate personal liability of a director for monetary damages for breach of fiduciary duty, except for breach of the duty of loyalty, acts or omissions not in good faith, intentional misconduct, knowing violation of law, unlawful dividends or improper personal benefit.
Interestingly, stockholders willingly and overwhelmingly have adopted these statutory protections for their directors. Issues involving allegations of the violation of the duty of care would most likely arise in connection with enterprise decisions made in corporate mid-life. On the other hand, many stockholders would prefer to eliminate or substantially curtail “defensive measures” such as poison pills often installed by the board and used by directors at the corporate end period, primarily in a hostile takeover context.

These are ownership issues as distinct from enterprise issues, and often involve an “enhanced” business judgment rule requiring directors to show that the defensive measure is reasonable in relation to the corporate threat. What is the reason for this “phenomenon” that stockholders eagerly favor eliminating liability of directors for lack of due care but are opposed to defensive measures? It is not really a phenomenon. It is quite understandable and predictable. Stockholders generally do not want directors to worry about negligence lawsuits because these suits are costly for the firm and distract the directors and officers from their mission—formation of capital and turning a profit to benefit stockholders.

The investors have said to the directors, in effect: “Don’t worry about personal liability in damages for negligence or even gross negligence; we will not only exempt you from such threats, but we will also provide you with indemnification and insurance protection, just in case. You are expected to devote your energies to doing good economic work for the firm, and that is to our benefit.”

But the stockholders likewise have said, in effect: “We do not excuse you from liability in damages for breach of your duty of loyalty, bad faith, intentional misconduct, improper personal benefit, etc. Nor do we like it when you erect draconian barriers that may inhibit an outside offer for our stock at a premium.”

Thus personal liability in damages for due care violations is not a practical worry for directors in their daily enterprise decisions. But it can be important, particularly in “end period” or “ownership” decisions for three reasons: First, the statutory exemption from personal liability in damages for negligence does not preclude injunctive or other
equitable relief in the transactional justification calculus. Second, a director must always act in good faith, so this raises the question: When is an act or omission so egregious and reckless that it evidences a lack of good faith? No director wants to be a defendant in a case testing those doctrinal borders.

Third, even if there are no personal liability concerns, a high-profile lack of due care by directors could undermine stockholder confidence, thus depressing the stock price, cause the directors to be ousted at the next election of directors, or may lead in the rare exercise of the stockholders’ statutory right of removal of the directors.

Nevertheless, the stockholders expect general principles of fiduciary duty to apply to the conduct of directors and that these fiduciary duties will be enforced by courts. Perhaps the most effective stockholder protection device is the independence of directors. Stockholders vote for directors and expect proper governance from them. The expectation is a strong bond of trust vested in the directors. Courts enforce that trust. At the same time, courts should be reluctant to interfere and should not create surprises or wild doctrinal swings in their expectations of directorial behavior.

But there is a paradox on the issue of the desirability of having a board predominately composed of independent directors. On the one hand, independent directors know less than interested ones about a firm. Actual governance (as distinct from simply hiring a chief executive officer and letting him or her work) takes time. An independent director has, by definition, less stake in the decision and, therefore, less incentive to get things right. What is the right balance of these considerations? Are investors necessarily better off with majority-independent boards? For many firms, boards dominated by insiders may be better because people with more time (and their money on the line) may well do better jobs.

Although independence of directors may not necessarily guarantee the best economic return to stockholders, the better view is that independence is a worthwhile goal of a significant majority of the board, but a blended board with independent directors and knowledgeable insiders may often be optimal. In the end, independence offers to
investors some further assurance that the governance process has integrity.

**Conclusion**

As long as we have judge-made law as the core of Delaware’s corporate law system, we must focus on ways to improve the reliance of investors and courts on board of directors operating at the heart of that system. Thus, we need to seek aspirational norms for good corporate practice. I have seven suggestions for boards of directors. These are recommended protocols offered only as an aspirational matter. They do not necessarily drive liability considerations, and they do not portend how a case will be decided. The seven suggestions are:

1) There should be a heavy majority of purely independent directors on every board.
2) The board should be engaged in actual governance, and not merely act as advisors to the CEO. This does not mean that the board runs the operations of the company (normally it should not). It means directors are in control of the policy of the firm, and the managers work for them.
3) The directors should meet face-to-face frequently throughout the year and spend substantial time on their homework. A norm of at least one hundred hours per year on each board has been suggested and seems reasonable, in my view. Of course more than the norm may be required in time of crisis, and directors should not become so over-committed that they cannot deal adequately with crises.
4) The directors should limit to a reasonable number the major boards on which they serve. What is a reasonable number depends on the extent to which each director is able to carry out his or her responsibilities to each board in a professional manner.
5) Independent directors should regularly evaluate the CEO, and they should meet with each other alone in executive session on a regular basis. The board should have independent audit, compensation and nominating committees. In most instances, at least the audit and compensation committees should be independently advised.
6) The board should establish and monitor reasonable law compliance programs.  
7) The board should carefully review disclosure documents for which they have direct responsibility to ensure that all material information reasonably available is disclosed to the relevant audience.

I should be clear that these suggestions are purely precatory. I am not foreshadowing how any case should be decided. The rationale of the economic expectations of investors is designed to be a coherent point of departure only and does not necessarily preordain any particularly result. Aspirations, like the seven protocols above, are not liability-related. At best, they may be in the nature of safe harbors in certain circumstances.

I recognize that the underlying premise that Delaware law is primarily based on judge-made law of fiduciary duty and that this is not necessarily the system in OECD countries. But the aspirations for good corporate governance principles can and should, in my view, be applied in all countries by the boards of directors themselves.