

Disloyalty without Limits: “Independent” Directors and the Elimination of the Duty of Loyalty

*J. Robert Brown, Jr.*¹

I. INTRODUCTION

WHATEVER one might say about the duties of corporate managers, there has been universal agreement that they must remain loyal to the company.² While loyalty can have a variety of meanings, the term unquestionably encompasses the notion that directors cannot use their position to profit unfairly from the company.³ It is this bedrock concept of fairness that theoretically places limits on self-interested transactions, particularly executive compensation.

Notwithstanding continued paeans to this proposition,⁴ Delaware courts have all but eliminated meaningful limits on self-interested transactions.⁵ Loans to officers and directors, for example, need not meet commercially reasonable standards;⁶ top officers may be paid excessive sums with no ju-

¹ Professor of Law, University of Denver College of Law; law clerk, Honorable Frank M. Johnson, Jr., United States Court of Appeals for the Eleventh Circuit. B.A. 1978, College of William & Mary; J.D. 1980, University of Maryland School of Law; Ph.D. 1993, Georgetown University. Thanks to Celia Taylor, Donald Clark, and Harvey Gelb for reading a draft and providing comments.

² The seminal case in the area is probably *Guth v. Loft, Inc.*, 5 A.2d 503 (Del. 1939). A debate did at one time appear in the literature about the possibility of shareholders and management contracting away the duty of loyalty. The topic ebbed without significant changes in the corporate law context. With respect to other entities, however, waiver or limits on the duty of loyalty have been permitted. *See* DEL. CODE ANN. tit. 6, § 18-1101 (2006) (allowing waiver of fiduciary duties in operating agreement of limited liability company).

³ *See* FLETCHER CYCLOPEDIA OF THE LAW OF CORPORATIONS § 837.60 (2006) (“The duty of loyalty is transgressed when a corporate fiduciary, whether director or officer, uses his or her corporate office to promote, advance or effectuate a transaction between the corporation and such person, and that transaction is not substantively fair to the corporation.” (citations omitted)).

⁴ Courts usually cite the hortatory language in *Guth v. Loft, Inc.* *See, e.g., In re LNR Prop. Corp. S’holders Litig.*, 896 A.2d 169, 175 (Del. Ch. 2005); *Benihana of Tokyo, Inc. v. Benihana, Inc.*, 891 A.2d 150, 191 (Del. Ch. 2005), *aff’d*, 906 A.2d 114 (Del. 2006).

⁵ Or, as one commentator has described, the Delaware courts have caused the duty to lie in a “persistent vegetative state.” Park McGinty, *The Twilight of Fiduciary Duties: On the Need for Shareholder Self-Help in an Age of Formalistic Proceduralism*, 46 EMORY L.J. 163, 169 (1997).

⁶ The facts surrounding Bernie Ebbers’ \$400 million loan from Worldcom, for example, suggests that it was not on commercially reasonable terms. *See* Worldcom, Inc., Current Report

dicial oversight of the fairness of the amount;⁷ and contributions may be made to charities favored by the CEO almost without limit.⁸

This did not happen all at once. Courts initially viewed conflict-of-interest transactions with considerable suspicion, often treating them as voidable.⁹ Over time, that approach gave way to a more workable rule requiring that the transaction be fair.¹⁰ Fairness amounted to a substantive limit—managers could profit from the corporation so long as they did not profit unfairly.

These limits, however, no longer apply. With little discussion, Delaware courts devised a set of procedures that rendered fairness irrelevant. So long as approved by a “neutral” decision-making body, a conflict-of-interest transaction is subject to review under the business judgment rule, a procedural standard rarely overcome and one that does not involve an examination of the terms of the transaction.¹¹ This approach contains serious flaws, some practical, some analytical, and some procedural.

(Form 8-K), at 292 (June 9, 2003) (“The loans from WorldCom provided Ebberts the funds with which to conduct his personal business affairs at advantageous interest rates. In making these loans and guaranties, WorldCom assumed risks that no financial institution was willing to assume. The Company did not have a perfected security interest in any collateral for the loans for most of the time period during which they were outstanding.”). To the extent that limits on such loans exist, they emanate from federal mandates rather than fiduciary obligations. *See* 15 U.S.C.A. § 78m(k) (West 2006). That particular limitation was only recently added by section 402 of Sarbanes-Oxley.

7 The amounts paid to top executives are substantial by any measure. *See* Lucian A. Bebchuk & Yaniv Grinstein, *The Growth of Executive Pay, Discussion Paper No. 510*, in THE HARVARD JOHN M. OLIN DISCUSSION PAPER SERIES (Harvard Law School ed., 2005) (noting that from 1993 to 2003, the top five executives at public companies totaled \$288 billion and from 2001 to 2003 they totaled about ten percent of all earnings). The Securities and Exchange Commission has adopted reforms designed to improve disclosure of executive compensation. *See* Executive Compensation and Related Party Disclosure, Exchange Act Release No. 34-54302A, 71 Fed. Reg. 53158 (Sept. 8, 2006).

8 *See infra* notes 19, 40 and accompanying text.

9 *See* Harold Marsh, *Are Directors Trustees? Conflict of Interest and Corporate Morality*, 22 BUS. LAW. 35, 36 (1966).

10 *See* *Freeman v. Decio*, 584 F.2d 186, 193 (7th Cir. 1978) (“Similarly, when scrutinizing transactions between a director or officer and the corporation under the light of the duty of loyalty, most courts now inquire as to whether there was any injury to the corporation, i.e., whether the transaction was fair and in good faith, before permitting the latter to avoid the transaction.”); *see also* *Norlin Corp. v. Rooney, Pace, Inc.*, 744 F.2d 255, 265 (2d Cir. 1984) (“Once self-dealing or bad faith is demonstrated, the duty of loyalty supersedes the duty of care, and the burden shifts to the directors to ‘prove that the transaction was fair and reasonable to the corporation.’” (quoting *Treadway Cos., Inc. v. Care Corp.*, 638 F.2d 357, 382 (2d Cir. 1980))).

11 The distinction matters. *See* Joel Seligman, *The New Corporate Law*, 59 BROOK. L. REV. 1, 7–8 (1993) (“The difference between a duty of loyalty review of a transaction where the defendants have the burden of persuading a court that the transaction was fair—that is, it would have been approved by a disinterested board negotiating at arm’s length with a stranger—and a business judgment rule analysis, where the plaintiff must persuade the court that a director

Analytically, the business judgment rule was not meant to apply to conflict-of-interest transactions.¹² Instead, it arose as an over-inclusive measure designed to protect managerial risk-taking. The business judgment rule does so by rendering the consequences of a decision essentially irrelevant. As long as the process used to make the decision is adequate, liability will not attach.¹³ The rationale does not apply, however, where the harm results not from risk-taking but from a conflict of interest.¹⁴

Delaware courts, however, have undone this approach. They apply the business judgment rule to cases involving a conflict of interest where a majority of the board is characterized as disinterested and independent.¹⁵ It makes no difference that the conflict remains present in the decision-making process. Indeed, the interested directors can sit in on the discussions, participate in the debate, and even vote on the transaction without the board losing its “neutral” status.

From a practical standpoint, Delaware courts do not adequately ensure that directors defined as independent are in fact independent. They routinely ignore evidence of a director’s connections to the interested party

or officer did not rationally believe that his or her business judgment was in the best interests of the corporation (a burden requiring proof in Delaware of the equivalent to gross negligence), is a fundamental one in corporate law. Directors and officers very rarely lose lawsuits when they are subject to a business judgment rule review. The odds are considerably less favorable when directors or officers themselves must prove the fairness of contracts or transactions they enter with their corporations.”).

12 William T. Allen, Jack B. Jacobs & Leo E. Strine, Jr., *Function over Form: A Reassessment of Standards of Review in Delaware Corporation Law*, 56 BUS. LAW. 1287 n.43 (2001) (“When it took that step, the law reflected the policy concern that an overly aggressive approach to enforcing the duty of care could deter risk-taking and discourage service on corporate boards by qualified candidates.”); see also George W. Dent, *The Power of Directors to Terminate Shareholder Litigation: The Death of the Derivative Suit?*, 75 NW. U. L. REV. 96, 135 (1980) (noting that the business judgment rule “insulate[s] from liability directors who have made mistaken decisions resulting in corporate losses, notwithstanding their good faith and exercise of due care”).

13 Thus, liability may not be imposed for negligent mismanagement. Delaware courts require at least a showing of gross negligence. See *infra* notes 22, 27. In fact, the standard is probably higher.

14 See Julian Velasco, *Structural Bias and the Need for Substantive Review*, 82 WASH. U. L.Q. 821, 834-35 (2004) (“Although the interests of directors usually are aligned with those of the shareholders, there are times when their interests conflict. In those situations, the deference afforded to directors by the business judgment rule is wholly inappropriate. Thus, when a plaintiff can establish a cognizable duty of loyalty issue, the protections of the business judgment rule are lost, and the directors’ actions are reviewed under the entire fairness test.” (footnote omitted)).

15 See *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984) (indicating that a transaction involving a conflict of interest is protected by the business judgment rule if it is approved by a majority consisting of the disinterested directors), *overruled in part by Brehm v. Eisner*, 746 A.2d 244 (Del. 2000).

and apply shifting and inconsistent tests.¹⁶ As a result, boards treated as having a majority of independent directors often in fact do not.

Procedurally, Delaware courts use pleading rules that prevent full examination of a director's relationship with the interested party. Facts rebutting the presumption of independence must be pled with particularity. Courts use this heightened standard to dismiss cases on motion without allowing for discovery. They do so even where plaintiffs have produced facts suggesting an absence of independence and where the additional information about the relationship is not publicly available.¹⁷

Despite the presence of interested influence in the decision making process and the absence of truly independent directors, courts apply the business judgment rule and defer to the board's decision. The results are predictable. They effectively ensure interested approval of interested transactions. Thus, the system can result in a salary of \$140 million paid for slightly more than one year of unsatisfactory work,¹⁸ \$130 million paid to build a museum to house the CEO's art collection,¹⁹ and a \$400 million loan on highly favorable terms,²⁰ without any examination of the fairness of the transaction.

This article will do four things. First, it will examine the evolution of the duty of loyalty, focusing on the replacement of fairness with the procedural "safeguards" of the business judgment rule. Second, the article will examine the definition of independence under Delaware law, concluding that directors who are not independent are routinely characterized as such. Third, it will analyze how boards use procedural requirements to prevent full examination of the independence issue. Finally, the article will suggest changes designed to ensure that limits on disloyalty remain in place and that fairness continues to matter.

16 *See, e.g.,* *Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart*, 845 A.2d 1040, 1050 (Del. 2004) ("Allegations of mere personal friendship or a mere outside business relationship, standing alone, are insufficient to raise a reasonable doubt about a director's independence.").

17 This can be seen from even a cursory reading of the cases. In rare moments of candor, the courts have occasionally acknowledged the problem. *See infra* note 121 and accompanying text.

18 *Brehm v. Eisner*, 746 A.2d 244, 253 (Del. 2000).

19 *See Kahn v. Sullivan*, 594 A.2d 48 (Del. 1991).

20 *See supra* note 6. The amount included both loans and guarantees. The loans were challenged not for violation of fiduciary obligations but for violations of the securities laws. *See In re Worldcom, Inc. Sec. Litig.*, 346 F. Supp. 2d 628 (S.D.N.Y. 2004).

II. THE DECLINE OF THE DUTY OF LOYALTY

A. *Fairness and the Duty of Care*

The *sine qua non* of a director's fiduciary duty is fairness. In cases not involving a conflict of interest, actions taken by the board are presumed fair,²¹ and are protected by the business judgment rule.²² Setting aside the business judgment rule requires evidence of a procedural deficiency;²³ the actual substance of the transaction and its fairness are largely irrelevant.²⁴

The business judgment rule is over-inclusive, exonerating more than good-faith errors of judgment or reasonable mistakes. To overcome the presumption plaintiffs must show at least gross negligence, and even then the ubiquitous²⁵ presence of waiver of liability provisions²⁶ will ordinarily

21 The business judgment rule does not apply to board inaction. See *Aronson v. Lewis*, 473 A.2d 805, 813 (Del. 1984) (“However, it should be noted that the business judgment rule operates only in the context of director action. Technically speaking, it has no role where directors have either abdicated their functions, or absent a conscious decision, failed to act. But it also follows that under applicable principles, a conscious decision to refrain from acting may nonetheless be a valid exercise of business judgment and enjoy the protections of the rule.”), *overruled in part by* *Brehm v. Eisner*, 746 A.2d 244 (Del. 2000). For the standards applicable to inaction, sometimes labeled the duty to monitor, see *In re Caremark International, Inc. Derivative Litigation*, 698 A.2d 959 (Del. Ch. 1996).

22 *Aronson*, 473 A.2d at 812. Said another way, “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.” *Brehm*, 746 A.2d at 264 n.66. This article does not address the heightened standards of board behavior that occurs during a change of control. For discussion on that topic, see, for example, *Revlon v. MacAndrews & Forbes Holding*, 506 A.2d 173 (Del. 1985) and *Unocal v. Mesa Petroleum*, 493 A.2d 946 (Del. 1985).

23 Wells M. Engledow, *Structuring Corporate Board Action to Meet the Ever-Decreasing Scope of Revlon Duties*, 63 ALB. L. REV. 505, 508 (1999) (“Thus, at bottom, the business judgment rule reflects little more than process inquiry.”). Successfully rebutting the presumption of the business judgment rule does not result in per se liability. Instead, the burden shifts to the directors to show the “entire fairness” of the transaction. See *McMullin v. Beran*, 765 A.2d 910, 923 (Del. 2000); *Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1156, 1162 (Del. 1995); *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 361 (Del. 1993), *modified*, 636 A.2d 956 (Del. 1994).

24 See *infra* note 34. Fairness does matter where the presumption of the business judgment rule is set aside. This, however, occurs rarely. See *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1984).

25 All fifty states have in place provisions that either limit liability of a breach of the duty of care or permit corporations to remove liability in the articles of incorporation. See J. Robert Brown, Jr., *The Irrelevance of State Corporate Law in the Regulation of Public Companies*, 38 U. RICH. L. REV. 317, 331–32 (2004).

26 See *Emerald Partners v. Berlin*, 787 A.2d 85, 92 (Del. 2001) (“Thus, under those specific circumstances, when the presumption of the business judgment rule has been rebutted in the shareholder complaint solely by successfully alleging a duty of care violation, the director defendants do not have to prove entire fairness to the trier of fact, because of the exculpation afforded to the directors by the section 102(b)(7) provision inserted by the shareholders

prevent recovery.²⁷ Plaintiffs are reduced to claims for waste,²⁸ which is an extraordinarily difficult standard to meet,²⁹ and one “very rarely satisfied.”³⁰

The business judgment rule protects risk-taking. Directors know that so long as they engage in proper procedures, they will be insulated from liability even if the transaction proves unsuccessful and causes harm to the company.³¹ The underlying logic does not apply, however, where the harm results from other motivations such as a desire to benefit parties interested in the outcome of the transaction.

B. Fairness and the Duty of Loyalty

1. *Obligation to Prove Fairness.*—At least some early courts considered the risks associated with self-dealing so great that they treated them as void-

into the corporation’s charter.”); *Malpiede v. Townson*, 780 A.2d 1075, 1094 (Del. 2001) (“As plaintiffs conceded in oral argument before this Court, if there is only an unambiguous, residual due care claim and nothing else—as a *matter of law*—then Section 102(b)(7) would bar the claim.”).

27 *See In re The Walt Disney Co. Derivative Litig.*, 907 A.2d 693, 750 (Del. Ch. 2005), *aff’d sub nom.* *Brehm v. Eisner*, 906 A.2d 27 (Del. 2006) (“Because duty of care violations are actionable only if the directors acted with gross negligence, and because in most instances money damages are unavailable to a plaintiff who could theoretically prove a duty of care violation, duty of care violations are rarely found.” (footnotes omitted)).

28 Waste “entails an exchange of corporate assets for consideration so disproportionately small as to lie beyond the range at which any reasonable person might be willing to trade.” *Lewis v. Vogelstein*, 699 A.2d 327, 336 (Del. Ch. 1997) (citations omitted).

29 *See In re The Walt Disney Co. Derivative Litig.*, 907 A.2d at 748–49 (“Corporate waste is very rarely found in Delaware courts because the applicable test imposes such an onerous burden upon a plaintiff—proving ‘an exchange that is so one sided that no business person of ordinary, sound judgment could conclude that the corporation has received adequate consideration.’” (footnote omitted)).

30 *Steiner v. Meyerson*, No. 15452, 1995 Del. Ch. LEXIS 95, at *3 (Del. Ch. July 19, 1995); *see also Brehm v. Eisner*, 746 A.2d 244, 263 (Del. 2000) (waste applicable in “unconscionable case where directors irrationally squander or give away corporate assets.”); *Harbor Fin. Partners v. Huizenga*, 751 A.2d 879, 892 (Del. Ch. 1999) (“The pleading burden on a plaintiff attacking a corporate transaction as wasteful is necessarily higher than that of a plaintiff challenging a transaction as ‘unfair’ as a result of the director’s conflicted loyalties or lack of due care.” (footnote omitted)). Some courts have questioned the need for an action for waste that survives the application of the business judgment rule. *See id.* at 895. Nonetheless, courts have long recognized that a board can be insulated from waste only by obtaining unanimous approval of shareholders. *See Lewis*, 699 A.2d at 327; *Saxe v. Brady*, 184 A.2d 602, 605 (Del. Ch. 1962).

31 The risk of failure is not irrelevant but close to it. The risk would be part of the “best interests” prong of the business judgment rule. To the extent failure was a certainty, it would be hard to argue that the transaction was in the best interests of the shareholders. On the other hand, to the extent failure was a strong possibility, a board could easily decide that it was still a risk worth taking.

able.³² Excessively narrow, the approach threatened to interfere with transactions beneficial to the corporation. Consequently, courts opted for a less restrictive test, allowing the transactions if substantively and procedurally fair. Procedural fairness meant approval by shareholders or disinterested directors.³³ Substantive fairness required “the earmarks of an arm’s length bargain.”³⁴ By the mid-twentieth century, however, it was enough to show substantive fairness,³⁵ with the burden on the board.³⁶

2. *Elimination of Fairness.*—The need to show substantive fairness imposed real limits on self-dealing. The approach did not prohibit transactions of unusual amounts or unusual terms, but it did impose on the board the obligation to affirmatively justify such transactions. Subject to personal liability for violations, directors were presumably less willing to approve self-interested transactions that might later be characterized as unfair. Thus, the

32 Marsh, *supra* note 9, at 36–39; *see also* Oberly v. Kirby, 592 A.2d 445, 466 (Del. 1991) (“At common law, a corporation’s stockholders did have the power to nullify an interested transaction, although considerations of the transaction’s fairness appear to have played some part in judicial decisions applying this rule.” (citations omitted)). Not everyone agrees with this early characterization. *See generally* Norwood P. Beveridge, Jr., *The Corporate Director’s Fiduciary Duty of Loyalty: Understanding the Self-Interested Director Transaction*, 41 DEPAUL L. REV. 655, 659–62 (1992) (asserting that interested director contracts were not always voidable); *see also* Norwood P. Beveridge, Jr., *Interested Director Contracts at Common Law: Validation under the Doctrine of Constructive Fraud*, 33 LOY. L.A. L. REV. 97, 98 (1999) (noting that Professor Marsh’s assertion has come under attack).

33 Marsh, *supra* note 9, at 39–40 (“[T]he general rule was that a contract between a director and his corporation was valid if it was approved by a disinterested majority of his fellow directors and was not found to be unfair or fraudulent by the court if challenged; but that a contract in which a majority of the board was interested was voidable at the instance of the corporation or its shareholders without regard to any question of fairness.” (footnote omitted)).

34 Byelick v. Vivadelli, 79 F. Supp. 2d 610, 629 (E.D. Va. 1999) (quoting Moneta v. Willard Bldg. Supply Co., 515 S.E.2d 277, 287 (Va. 1999)). As one commentator noted, fairness represented what “would have been approved by a disinterested board negotiating at arm’s length with a stranger” Joel Seligman, *The New Corporate Law*, 59 BROOK. L. REV. 1, 7 (1993) (footnote omitted).

35 Harvey Gelb, *Corporate Governance and the Independence Myth*, 6 WYO. L. REV. 129, 130 (2006) (“The general rule by the mid-twentieth century would uphold the validity of a transaction even in the absence of a disinterested director majority vote unless it was found by the court to be unfair to the corporation.”).

36 *See* Emerald Partners v. Berlin, 726 A.2d 1215, 1222 (Del. 1999) (“Once the entire fairness standard has been implicated, as here, the defendants, at least initially, bear the burden of demonstrating the two basic aspects of fair dealing and fair price.” (citation omitted)); Mills Acquisition Co. v. MacMillan, Inc., 559 A.2d 1261, 1280 (Del. 1989) (“When faced with such divided loyalties, directors have the burden of establishing the entire fairness of the transaction to survive careful scrutiny by the courts.”); Keenan v. Eshleman, 2 A.2d 904 (Del. 1938) (“In the second place, dealing as they did with another corporation of which they were sole directors and officers, they assumed the burden of showing the entire fairness of the transaction.”).

burden of showing fairness threatened to generate a risk-averse approach to these types of transactions.

Courts took a number of steps to mitigate the full implications of the obligation to show fairness. They limited the category of “self-dealing” transactions that triggered application of the duty of loyalty. The duty did not apply, for example, where the benefits were shared equally by all shareholders,³⁷ despite the continued risk of self-serving behavior.³⁸ Neither was the duty held applicable to transactions where the conflict was immaterial³⁹ or involving non-pecuniary gain.⁴⁰

The most significant inroads, however, involved the use of process as a substitute for substantive fairness. The courts concluded, with almost no analysis, that fairness would be presumed where the transaction was approved by a board containing a majority of independent and disinterested directors. In those circumstances, review would be limited to the almost insurmountable business judgment rule.⁴¹

37 *See* *Fink v. Weill*, No. 02 Civ. 10250, 2005 U.S. Dist. LEXIS 20659, at *12 (S.D.N.Y. Sept. 19, 2005) (“A director is considered to be interested where the director is positioned to receive a personal financial benefit from a transaction that would not be equally shared by the corporation or shareholders or where a transaction would be materially detrimental to the director but not to the corporation or shareholders.” (citation omitted) (applying Delaware law)); *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984) (noting that directors must obtain a “personal financial benefit” as opposed to a benefit “which devolves upon the corporation or all stockholders generally” (citations omitted)), *overruled in part by* *Brehm v. Eisner*, 746 A.2d 244 (Del. 2000); *Sinclair Oil Corp. v. Levein*, 280 A.2d 717, 721–22 (Del. 1971) (finding that the duty of loyalty did not apply since all shareholders received the same proportionate dividend even though the court assumed that the board of the subsidiary paying the dividend was entirely dominated by the parent).

38 *See* *Marsh*, *supra* note 9, at 63 (“A common example is the situation where a controlling shareholder owns a large block of stock and, because of his tax bracket and the fact that he is receiving a handsome salary, does not want to receive dividends; but a substantial amount of stock is in the hands of the public.”).

39 *See* *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 363 (Del. 1993), *modified*, 636 A.2d 956 (Del. 1994); *Orman v. Cullman*, 794 A.2d 5, 27 (Del. Ch. 2002). Materiality is found where the benefit is significant enough “in the context of the director’s economic circumstances, as to have made it improbable that the director could perform her fiduciary duties to the . . . shareholders without being influenced by her overriding personal interest.” *In re* Gen. Motors Class H S’holders Litig., 734 A.2d 611, 617 (Del. Ch. 2001) (citations omitted).

40 Thus, for example, in *Kahn*, the board of directors of Occidental approved expenditures designed to construct a museum that would house the art collection of the CEO and chairman of the board. *See* *Kahn v. Sullivan*, 594 A.2d 48 (Del. 1991). The court ignored the non-pecuniary conflict of interest (by having the company fund the museum, the CEO benefited by controlling the terms and circumstances of the artwork’s display), and instead reviewed the transaction under the duty of care. *See id.*

41 *See* *Oberly v. Kirby*, 592 A.2d 445, 466 n.14 (Del. 1991) (noting in dicta that “[a] court will defer to the business judgment of outside directors that an interested transaction is fair to the corporation”); *In re* Resorts Int’l S’holders Litig. Appeals, 570 A.2d 259, 266–67 (Del. 1990) (merger agreement “had been approved by an independent and disinterested special committee and therefore would be accorded the presumption of the business judgment rule’s

The approach required a subtle but fundamental shift in the interpretation of fiduciary obligations. The *sine qua non* of the business judgment rule was no longer the absence of a conflict of interest⁴² but the presence of a “neutral decision making body.”⁴³ Rather than defining “neutral” as a board devoid of a conflict of interest, something that could be accomplished through elimination⁴⁴ or quarantine,⁴⁵ the courts instead opted for a standard that had nothing to do with the conflict itself.⁴⁶ It was enough to show that a majority of the directors were independent and disinterested.⁴⁷

application” (citations omitted)); *Ivanhoe Partners v. Newmont Mining Corp.*, 535 A.2d 1334, 1345 (Del. 1987) (“[T]he board’s actions taken by a majority of independent directors, are entitled to the protection of the business judgment rule.” (citations omitted)); *In re Trans World Airlines, Inc. S’holders Litig.*, No. 9844, 1988 Del. Ch. LEXIS 139, at *19 (Del. Ch. Oct. 21, 1988) (“Both the device of the special negotiating committee of disinterested directors and the device of a merger provision requiring approval by a majority of disinterested shareholders, when properly employed, have the judicial effect of making the substantive law aspect of the business judgment rule applicable and, procedurally, of shifting back to plaintiffs the burden of demonstrating that such a transaction infringes upon rights of minority shareholders.”).

42 *See Lewis v. S. L. & E., Inc.*, 629 F.2d 764, 769 (2d Cir. 1980) (“But the business judgment rule presupposes that the directors have no conflict of interest.”).

43 *Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1156, 1170 (Del. 1995); *see also Nixon v. Blackwell*, 626 A.2d 1366, 1376 (Del. 1993) (“In business judgment rule cases, an essential element is the fact that there has been a business decision made by a disinterested and independent corporate decisionmaker.”); *Oberly*, 592 A.2d at 467 (“The key to upholding an interested transaction is the approval of some neutral decision-making body.”).

44 *Cede & Co.*, 634 A.2d at 366 n.35 (“Examples of techniques which can restrict the influence an interested director may exert include: recusal of the interested director(s) from participation in board meetings . . .” (citations omitted)).

45 A disinterested and independent committee would be one possible mechanism for quarantining a conflict of interest. This has been the approach used, for example, in the context of board consideration of derivative suits. *See Zapata Corp. v. Maldonado*, 430 A.2d 779, 786 (Del. 1981) (“We do not think that the interest taint of the board majority is per se a legal bar to the delegation of the board’s power to an independent committee composed of disinterested board members. The committee can properly act for the corporation to move to dismiss derivative litigation that is believed to be detrimental to the corporation’s best interest.”). Whether the conflict could ever be eliminated, even with a rigorous quarantine, remains an open question. *See Marsh, supra* note 9, at 37–38 (discussing early cases, found that it was “impossible to measure the influence” of interested directors on the board and, as a result, courts gave little weight to disinterested approval). Delaware, however, has rejected this view. *See Cede & Co.*, 634 A.2d at 363.

46 *See Cede & Co.*, 634 A.2d at 363 (“This Court has never held that one director’s colorable interest in a challenged transaction is sufficient, without more, to deprive a board of the protection of the business judgment rule presumption of loyalty.”).

47 *See Cinerama, Inc.*, 663 A.2d at 1170 n.25 (“A board of which a majority of directors is interested is not a ‘neutral decision-making body.’” (citations omitted)); *Nixon*, 626 A.2d 1376 n.7 (independent corporate decisionmaker “could be a disinterested and independent majority of the board of directors or the stockholders” (citation omitted)); *Cal. Pub. Employees Ret. Sys. v. Coulter*, No. 19191, 2002 Del. Ch. LEXIS 144, at *22 (Del. Ch. Dec. 18, 2002) (“Furthermore, when a director’s compensation is established by a majority of disinterested directors, the business judgment rule applies to the decision.” (footnote omitted)); *Orman v.*

Directors with a conflict of interest could remain on the board, participate in the decision, and vote on the final outcome without depriving the board of its neutral status.

This approach reduced the concept of neutrality to a rote head count. The analysis did not require any assessment of the qualitative impact of the interested influence. A board with a majority of independent directors was neutral, a board without was not.⁴⁸ A shift in the independence of a single director could result in the application of radically different standards of review.⁴⁹

Cullman, 794 A.2d 5, 22 (Del. Ch. 2002) (“To rebut successfully business judgment presumptions . . . a plaintiff must normally plead facts demonstrating ‘that a *majority* of the director defendants have a financial interest in the transaction or were dominated or controlled by a materially interested director.’” (footnote omitted)); *Crescent/Mach I Partners, LP v. Turner*, 846 A.2d 963 (Del. Ch. 2000); *see also* *McMichael v. U.S. Filter Corp.*, No. EDCV 99-182 VAP, 2001 US Dist. LEXIS 3918, at *44 (C.D. Cal. Feb. 26, 2001) (“To prevail on their breach of loyalty claim, Plaintiffs must overcome the Business Judgment Rule presumption and show a majority of the U.S. Filter Directors had personal interest potentially adverse to the interests of U.S. Filter and its shareholders.” (citation omitted) (applying Delaware law)); *Cede & Co.*, 634 A.2d at 363–64 (“Neither *Aronson* nor *Pogostin* can be fairly read to support Cinerama’s thesis that a finding of one director’s possession of a disqualifying self-interest is sufficient, without more, to rebut the business judgment presumption of director/board loyalty; and no Delaware decisional law of this Court supports such a result.”).

48 Majority meant majority, unless inconvenient. Evenly divided will not do; the independent directors must be a majority. *See* *Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart*, 845 A.2d 1040, 1046 (Del. 2004) (“If three directors of a six person board are not independent and three directors are independent, there is not a majority of independent directors and demand would be futile.” (citation omitted)); *see also* *Beneville v. York*, 769 A.2d 80, 86 (Del. Ch. 2000) (holding that demand is excused where a board is evenly divided between interested and disinterested directors). On the other hand, Delaware courts have allowed boards to create a disinterested majority through the use of recusals. *See* *Ivanhoe Partners v. Newmont Mining Corp.*, 535 A.2d 1334, 1339 n.10 (Del. 1987) (noting the deference to a board that consisted of nine directors, with only four qualifying as independent. Because two of the interested directors “recused” themselves, the court found that the four independent directors constituted a majority).

49 For example, in *In re Viacom, Inc. Shareholder Derivative Litigation*, 235 N.Y.L.J. 126 (N.Y. Sup. Ct. June 23, 2006), plaintiffs challenged compensation in excess of \$150 million paid to three officers in a year when the company experienced losses in excess of \$17 billion. With defendants conceding that five of the twelve directors were not independent, the case turned upon whether plaintiffs could sufficiently allege facts showing that one additional director had a disqualifying relationship. The court examined three directors and their connections to the company, ultimately concluding that one might not be independent. *Id.* at 11–12 (“The fact that [the director] advised [the CEO] in his personal affairs in two large acquisitions, provided services and continues to provide services to Viacom is sufficient to create a reasonable doubt as to his ability to evaluate plaintiffs’ demand without a taint of interest, ‘extraneous considerations’ or influences.”). In other words, the continuation of the case and the application of the duty of loyalty turned on the relationship of one director. Had the director provided a little less personal advice to an executive, the case would have been dismissed and the duty of loyalty rendered inapplicable.

*Citron v. Fairchild*⁵⁰ illustrates the high degree of interested influence allowed in the decision-making process while still applying the business judgment rule. The Fairchild Camera board consisted of ten persons, including Wilfred Corrigan, the CEO, president, and chairman. After receiving an unsolicited takeover offer from Gould, Inc., Corrigan expressed opposition and sought a white knight.⁵¹ Schlumberger, Inc. surfaced as a possible rescuer, with Corrigan participating in the negotiations and apparently receiving a commitment that he would be retained “as president and CEO”.⁵² During the same period, he refused to meet with officials from Gould⁵³ and assisted the removal of a Fairchild director who was friends with that company’s chairman.⁵⁴ Ultimately, the board of Fairchild rejected a higher offer from Gould, and accepted a lower one from Schlumberger.

The facts suggested a possible conflict of interest by Corrigan. He demonstrated a hostile “animus” towards Gould and had expectations of continued post-merger employment with Schlumberger. Moreover, as the CEO, president, and chairman, Corrigan presumably had considerable sway over the other members of the board. He remained involved in various negotiations and participated in the board meetings where key decisions were made.

50 *Citron v. Fairchild Camera & Instrument Corp.*, 569 A.2d 53 (Del. 1989).

51 *Citron v. Fairchild Camera & Instrument Corp.*, No. 6085, 1988 Del. Ch. LEXIS 67 (Del. Ch. May 19, 1988) (“Mr. Corrigan also expressed his own strong reservations about a combination with Gould. In particular, he expressed concern that Fairchild personnel would not fit into what he characterized, according to one witness, as a ‘highly centralized monolithic organization.’ Corrigan clearly was not pleased by Gould’s proposal.”), *aff’d*, 569 A.2d 53 (Del. 1988). Corrigan’s opposition caused the court to conclude that he “exhibit[ed] some animus toward Gould.” *Citron*, 569 A.2d at 65; *see also id.* (“He considered Gould a ‘highly centralized monolithic organization’ and informed the other directors that he ‘personally didn’t want to be part of such a combination.’”). As the court described: “Corrigan expressed himself as unequivocally opposed to Gould’s proposal. Corrigan did not like what he had heard about Gould.” *Id.* at 57.

52 *Citron*, 1988 Del. Ch. LEXIS 67, at *24. They also discussed Corrigan’s future with Schlumberger and the possibility of a position for him on the board. *See id.* (“After that time period, according to Corrigan’s testimony at trial, he told Riboud that the only circumstances under which he could visualize remaining were if he had a position as a director of Schlumberger. Riboud responded, according to Corrigan’s testimony, that although it was not the appropriate time to discuss it, if things went well during the transition and if both sides wanted Corrigan to remain, a directorship ‘was in the cards.’”). In his deposition, Corrigan indicated that the promise of a board position was a “commitment.” This was arguably even more important given the original bidder’s reputation for taking a “ruthless” approach to replacing existing management.

53 The chairman of Gould indicated a desire to meet with Corrigan. Corrigan refused for “tactical” reasons. *Id.*

54 *Citron*, 569 A.2d at 58 (“The following day, May 4, at Fairchild’s annual meeting, its shareholders reelected all incumbent directors except Louis F. Polk, Jr., who had not been renominated due, in part, to Corrigan’s displeasure with Polk’s friendship with Ylvisaker [the chairman of Gould, Inc.]”)

Corrigan's influence, however, remained largely irrelevant to the analysis. The plaintiff's case was reduced to a rote count of the number of independent and disinterested directors. With the majority deemed independent, the court applied the business judgment rule, acting as if Corrigan's opposition or influence did not exist. The standard obviated the board's obligation to show fairness or to justify why it accepted the lower priced offer.⁵⁵

3. *Source of the Rule Eliminating Fairness.*—Application of the business judgment rule in cases like *Fairchild* is hard to justify.⁵⁶ The source of the approach has never been entirely explained. It seems to have arisen in part from an inaccurate reading of section 144(a) of the Delaware Corporate Code.⁵⁷

The provision provides that certain conflicts of interest are not "void or voidable" where approved by the "affirmative votes of a majority of the

55 *See In re The Ltd., Inc. S'holders Litig.*, No. 17148-NC, 2002 Del. Ch. LEXIS 28, at *28 (Del. Ch. Mar. 27, 2002) (noting that the transaction benefited the CEO/Chairman and largest shareholder; the court did not examine his influence on the negotiations, but required plaintiff to show that a majority of directors were not independent and disinterested).

56 Despite pursuing the business judgment rule approach, however, courts have left open the possibility that a plaintiff can show that an interested party exercised control over independent directors. *See Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 364 (Del. 1994) ("We agree with defendants that the question of when director self-interest translates into board disloyalty is a fact-dominated question, the answer to which will necessarily vary from case to case."), *modified*, 636 A.2d 956 (Del. 1994); *see also Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1156, 1170 n.25 (Del. 1995) ("Similarly, the manipulation of the disinterested majority by an interested director vitiates the majority's ability to act as a neutral decision-making body." (citation omitted)). Given obvious difficulties in proof and heightened pleading standards, this rarely occurs. *But see In re LNR Prop. Corp. S'holders Litig.*, 896 A.2d 169 (Del. Ch. 2005) (refusing to dismiss suit against individual directors in which plaintiff made allegations that controlling shareholder negotiated the terms of the merger).

57 The provision by its terms does not require approval by disinterested shareholders. *See DEL. CODE ANN.* tit. 8, § 144(a) (2006). Nonetheless, it is often cited for the proposition. *See Cede & Co.*, 634 A.2d at 366 n.34 ("Under this statute, approval of an interested transaction by either a fully-informed disinterested board of directors, 8 Del. C. § 144(a)(1), or the disinterested shareholders, 8 Del. C. § 144(a)(2), provides business judgment protection." (citation omitted)); *Marciano v. Nakash*, 535 A.2d 400, 405 n.3 (Del. 1987) ("On the other hand, approval by fully-informed disinterested directors under section 144(a)(1), or disinterested stockholders under section 144(a)(2), permits invocation of the business judgment rule and limits judicial review to issues of gift or waste with the burden of proof upon the party attacking the transaction."). The reference has been repeated more recently. *See Rosser v. New Valley Corp.*, No. 17272-NC, 2005 Del. Ch. LEXIS 81, at *17 n.23 (Del. Ch. May 27, 2005). *But see In re Cysive, Inc. S'holders Litig.*, 836 A.2d 531, 550 n.23 (Del. Ch. 2003) (citing section 144 for the proposition that merger is not voidable if "approved by a majority of disinterested directors or a majority of disinterested stockholders."). For a discussion of the mistaken interpretation, see J. Robert Brown, Jr., *Speaking with Complete Candor: Shareholder Ratification and the Elimination of the Duty of Loyalty*, 54 HASTINGS L.J. 641 (2003).

disinterested directors . . .”⁵⁸ A number of courts have relied on the language to justify the application of the business judgment rule,⁵⁹ apparently concluding that the approval mechanism somehow removes the “taint” of the conflict of interest.⁶⁰

This interpretation is wrong for a number of reasons. Most noticeably, section 144(a) addresses voidability,⁶¹ not the standard of review for a non-

⁵⁸ § 144(a); *see also* *Benihana of Tokyo, Inc. v. Benihana, Inc.*, 891 A.2d 150, 185 (Del. Ch. 2005) (“Satisfying the requirements of § 144 only means that the BFC Transaction is not void or voidable *solely* because of the conflict of interest.”), *aff’d*, 906 A.2d 114 (Del. 2006); *HMG/Courtland Props., Inc. v. Gray*, 749 A.2d 94, 114 n.24 (Del. Ch. 1999) (“Rather, satisfaction of §§ 144(a)(1) or (a)(2) simply protects against invalidation of the transaction solely because it is an interested one.” (citation omitted)).

⁵⁹ The observation was made in *Oberly v. Kirby*, 592 A.2d 445, 466 (Del. 1991) (“First, section 144 allows a committee of disinterested directors to approve a transaction and bring it within the scope of the business judgment rule.”). The case neither involved a transaction under section 144 nor a for-profit corporation. Nonetheless, in *Cinerama, Inc.*, 663 A.2d 1156, the Delaware Supreme Court extended the doctrine to the traditional corporate area. The opinion noted: “In *Oberly*, even though Section 144(a) did not apply to the action being contested, this Court relied upon the provisions in that statute to illustrate the general principle that, as to the duty of loyalty, approval of a transaction by a board of which a majority of directors is disinterested and independent ‘brings it within the scope of the business judgment rule.’” *Id.* at 1170 (citation omitted); *see also* *Kahn ex rel DeKalb Genetics Corp. v. Roberts*, No. 12324, 1995 Del. Ch. LEXIS 151, at *13 (Del. Ch. Dec. 6, 1995) (“The business judgment rule will shelter a transaction from shareholder challenge if a panel of independent directors approves it. 8 Del. C. § 144(a)”) (footnote and citations omitted), *aff’d*, 679 A.2d 460 (Del. 1996); *Cede & Co.*, 634 A.2d at 366 n.34 (“[S]ection 144 removes the “interested director cloud” from a transaction through three alternative methods and permits an otherwise interested transaction to be brought within the protection of the business judgment rule.” (citations omitted)). As recently as 2003, the Delaware Supreme Court cited Section 144 (and *Aronson*) for the proposition that the business judgment rule applied unless a majority of the directors were interested in the transaction. *See* *Krasner v. Moffett*, 826 A.2d 277, 287 n.39 (Del. 2003). Other courts have repeated the position. *See* Official Comm. of Unsecured Creditors v. Aust (*In re* Network Access Solutions Corp. & NASOP, Inc.), 330 B.R. 67, 78 (Bankr. D. Del. 2005) (“The decision of a majority of the disinterested directors to execute a transaction with an interested director is subject to the business judgment rule.” (citation omitted)).

⁶⁰ *See* *Nebenzahl v. Miller*, No. 13206, 1996 Del. Ch. LEXIS 113, at *10–11 (Del. Ch. Aug. 26, 1996) (“Compliance with Section 144 provides the protection of the business judgment rule and removes the taint of director self-interest in a transaction.” (citations omitted)); *see also* *Cede & Co.*, 634 A.2d at 365 (“Section 144(a)(1) appears to be a legislative mandate that, under such circumstances, an approving vote of a majority of informed and disinterested directors shall remove any taint of director or directors’ self-interest in a transaction.” (citation omitted)).

⁶¹ So the general rule seems to be with these types of statutes. *See* Bruce A. McGovern, *Fiduciary Duties, Consolidated Returns, and Fairness*, 81 NEB. L. REV. 170, 187 (2002) (“The courts, however, generally have viewed such statutes as displacing only the common law’s original rule that directors’ self-dealing transactions were automatically voidable.” (footnote omitted)); *see also* *Oberhelman v. Barnes Inv. Corp.*, 690 P.2d 1343, 1349–50 (Kan. 1984) (finding that under KAN. STAT. ANN. § 17-6304, which is identical to DEL. CODE ANN. tit. 8, § 144, approval by disinterested directors does not preclude review for fairness) (citing *Fliegler v. Lawrence*, 361 A.2d 218 (Del. 1976)). Thus, it is not quite right to say that there is near una-

voidable transactions.⁶² Nothing in the language or the purpose of the provision compels application of the business judgment rule.⁶³ Moreover, the structure of the provision militates against any such interpretation. In addition to disinterested directors, section 144(a) permits approval by all shareholders (not just disinterested ones). Using a consistent logic, transactions authorized by shareholders (even where the interested party owns a majority) would be subject to the business judgment rule, an absurd position that is not accepted by the courts.⁶⁴

The absence of a logical rationale for this position has resulted in inconsistent application. The business judgment rule does not apply to transactions between a company and a controlling shareholder,⁶⁵ even if approved

nimity on applying the business judgment rule in the case of approval by a board with a majority of disinterested directors. *But see* Dennis J. Block, Stephen A. Radin & Michael J. Maimone, *Derivative Litigation: Current Law Versus the American Law Institute*, 48 *BUS. LAW.* 1443, 1443–44 (1993) (“[C]ourts both in and out of Delaware have ruled with near unanimity . . . that the business judgment rule is the appropriate standard of judicial review in cases where an independent majority of a corporation’s board of directors determines that litigation on behalf of the corporation will not serve the best interests of the corporation.”).

62 Similar statutes exist in most states. In general, they have not been interpreted to eliminate fairness from the analysis. *See* Marsh, *supra* note 9, at 46–47; William W. Bratton, *Self-Regulation, Normative Choice, and the Structure of Corporate Fiduciary Law*, 61 *GEO. WASH. L. REV.* 1084, 1088 (1993) (“They have consistently construed them to permit direct judicial review for fairness despite disinterested-director approval.” (footnote omitted)).

63 Thus, as one Delaware court has noted, the true source of the requirement is common law. *See In re Cox Commc’ns, Inc. S’holders Litig.*, 879 A.2d 604, 614–15 (Del. Ch. 2005) (“§ 144 has been interpreted as dealing solely with the problem of per se invalidity; that is, as addressing only the common law principle that interested transactions were entirely invalid and providing a road map for transactional planners to avoid that fate. The somewhat different question of when an interested transaction might give rise to a claim for breach of fiduciary duty—i.e., to a claim in equity—was left to the common law of corporations to answer. Mere compliance with § 144 did not necessarily suffice.” (footnote omitted)).

64 In a case decided just before the adoption of section 144, the Delaware Supreme Court reaffirmed that approval by “disinterested” shareholders merely shifted the burden of showing fairness. *See Alcott v. Hyman*, 208 A.2d 501, 505 (Del. 1965); *see also In re Cox Commc’ns, Inc. S’holders Litig.*, 879 A.2d at 615 (“By its own terms, Section 144 alleviates the possibility of per se invalidity by a vote of stockholders, without any explicit requirement that a majority of the disinterested stockholders approve. The common law, by contrast, only gives ratification effect to approval of the interested transaction by a majority of the disinterested stockholders.” (footnotes omitted)). In fact, the MBCA originally contained similar language concerning shareholder approval but specifically excluded the votes of the interested director. *See Sobek v. Stonitsch*, 995 F. Supp. 918, 920 (N.D. Ill. 1998). For a discussion of this anomaly, *see Liston v. Gottsegen (In re Mi-Lor Corp.)*, 348 F.3d 294 (1st Cir. 2003).

65 Courts sometimes add “or dominating” to the category of shareholders subject to the standards. *See Kahn v. Lynch Commc’n Sys.*, 638 A.2d 1110, 1117 (Del. 1994) (“Once again, this Court holds that the exclusive standard of judicial review in examining the propriety of an interested cash-out merger transaction by a controlling or dominating shareholder is entire fairness.” (citation omitted)); *see also In re PNB Holding Co. S’holders Litig.*, No. 28-N, 2006 Del. Ch. LEXIS 158, at *30 (Del. Ch. Aug. 18, 2006) (“Remember that the Delaware case law in this area (that is, the *Lynch* line of jurisprudence) has been premised on the notion that

by a board containing a majority of independent and disinterested directors.⁶⁶ Instead, companies are obligated to remove the interested influence from the decision-making process through the use of a special committee.⁶⁷ Even then, the decisions do not receive the presumption of fairness contained in the business judgment rule,⁶⁸ but merely shifts the burden to the shareholders to show a lack of fairness.⁶⁹ Thus, in the case of a control-

when a controller wants the rest of the shares, the controller's power is so potent that independent directors and minority stockholders cannot freely exercise their judgment, fearing retribution from the controller. For this reason (which is in great tension with other aspects of our law), the jurisprudence has required that such transactions always be subject to fairness review." (footnotes omitted)).

66 See *In re LNR Prop. Corp. S'holders Litig.*, 896 A.2d 169, 177 (Del. Ch. 2005) ("[T]he business judgment rule does not protect the board's decision to approve a merger (even where a majority of the directors are independent and disinterested) where a controlling shareholder has a conflicting self-interest.").

67 See William T. Allen, Jack B. Jacobs & Leo E. Strine, Jr., *Function Over Form: A Reassessment of Standards of Review in Delaware Corporation Law*, 56 BUS. LAW. 1287, 1308 (2001) ("We recognize that the integrity of the special disinterested director committee process remains subject to debate. The argument against according that process business judgment review is that although most public company boards have a majority of independent directors, those directors are not hermetically sealed off from the inside directors. It is commonplace for outside directors to have social, and in some cases business, relationships (e.g., a partner in the company's outside law firm or investment bank serving as a director). That reality may explain the Delaware Supreme Court's reluctance to give the special committee device full credit as a cleansing mechanism. It may also provide a basis for withholding full ratification effect to board approval of transactions achieved in that fashion.").

68 See *In re Cysive, Inc., S'holder Litig.*, 836 A.2d 531 (Del. Ch. 2003); *In re Trans World Airlines, Inc. S'holders Litig.*, No. 9844, 1988 Del. Ch. LEXIS 139, at *20 (Del. Ch. Oct. 21, 1988) (declaring that approval by independent negotiating committee results in "burden shifting effect" with respect to "the entire fairness of the transaction"). This is true whether disinterested approval is by directors or shareholders. See *In re LNR Prop. Corp. S'holders Litig.*, 896 A.2d at 178 n.52 ("While the initial burden of establishing entire fairness rests on the defendant party, an approval of the transaction by an independent and disinterested board or Special Committee, as well as an informed majority of minority vote, shifts the burden of proof on the issue of fairness to the challenging shareholder plaintiffs."); *Rosser v. New Valley Corp.*, No. 17272-NC, 2005 Del. Ch. LEXIS 81, at *18 (Del. Ch. May 27, 2005) ("On the other hand, if implementation of the Plan is considered to be the result of actions taken by a controlling shareholder group, the effect of approval by fully informed and disinterested shareholders may simply be to shift to the Plaintiff the burden of demonstrating that the transaction was not entirely fair."). A recent court, however, suggested that the appropriate standard of review for a recommendation by a special committee might be an open question. See *Krasner v. Moffett*, 826 A.2d 277, 286 (Del. 2003) ("Beyond that, it is premature to determine the legal effect—and the resulting standard of review—that would apply if a special committee that operated independently recommended a merger to the full board.").

69 One chancery court opinion has suggested applying the business judgment rule where approved by both disinterested directors and shareholders. See *In re Cox Commc'ns, Inc. S'holders Litig.*, 879 A.2d at 606 ("The reform would be to invoke the business judgment rule standard of review when a going private merger with a controlling stockholder was effected using a process that mirrored *both* elements of an arms-length merger: 1) approval by disinterested directors; and 2) approval by disinterested stockholders. The two elements are

ling shareholder, fairness remains an element of the claim, albeit with the obligation on the plaintiffs.

The courts have never provided an adequate explanation for the differing standards.⁷⁰ Cases involving short-form mergers suggested that the business purpose of the transaction had no place in the analysis,⁷¹ a view some have criticized.⁷² Others indicated a concern about possible retaliation by the controlling shareholder.⁷³ As one court explained:

[M]ergers with controlling stockholders involve an extraordinary potential for the exploitation by powerful insiders of their informational advantages and their voting clout. Facing the proverbial 800 pound gorilla who wants the rest of the bananas all for himself, chimpanzees like independent directors and disinterested stockholders could not be expected to make sure that the gorilla paid a fair price. Therefore, the residual protection of an unavoidable review of the financial fairness whenever plaintiffs could raise a genuine dispute of fact about that issue was thought to be a necessary final protection.⁷⁴

complementary and not substitutes.”).

70 *See also In re W. Nat'l Corp. S'holders Litig.*, No. 15927, 2000 Del. Ch. LEXIS 82, at *87–88 (Del. Ch. May 22, 2000) (“The policy rationale requiring some variant of entire fairness review, to my mind, substantially, if not entirely, abates if the transaction in question involves a large though not controlling shareholder. In other words, because the absence of a controlling shareholder removes the prospect of retaliation, the business judgment rule should apply to an independent special committee’s good faith and fully informed recommendation.” (footnote omitted)).

71 *Weinberger v. UOP, Inc.*, 457 A.2d 701, 715 (Del. 1983) (“[W]e do not believe that any additional meaningful protection is afforded minority shareholders by the business purpose requirement of the trilogy of *Singer, Tanzer, Najjar*, and their progeny. Accordingly, such requirement shall no longer be of any force or effect.” (footnotes and citation omitted)); *see also Kahn v. Lynch Commc'ns Sys., Inc.*, 638 A.2d 1110 (Del. 1994); *In re W. Nat'l Corp.*, 2000 Del. Ch. LEXIS 82, at *78–79.

72 As one court noted: “That is an odd and unsatisfying rationale, which, if taken seriously, would have implications for all decisions by directors who agree to cash mergers.” *In re Cox Commc'ns*, 879 A.2d at 617.

73 *See In re Cox Commc'ns, Inc., S'holders Litig.*, 879 A.2d at 616 (“Their fear that the controller would retaliate against a negative vote, Vice Chancellor Jacobs suggested, rendered a Minority Approval Condition an insufficient guarantee of fairness in this unique transactional context to give that vote ratification effect.” (footnote omitted)); *see also In re Cysive, Inc., S'holder Litig.*, 836 A.2d at 548 (“The rationale for this rule is that the potential power of the controlling stockholder to act in ways that are detrimental to independent directors and unaffiliated stockholders is supposedly so formidable that the law’s prohibition of retributive action and unfair self-dealing is insufficient to render either independent director or independent stockholder approval a reliable guarantee of fairness.” (footnote omitted)).

74 *In re Cox Commc'ns, Inc., S'holders Litig.*, 879 A.2d at 617 (footnote omitted); *see also In re Tele-Commc'ns, Inc. S'holders Litig.*, No. 16470, 2005 Del. Ch. LEXIS 206, at *25–26 (Del. Ch. Dec. 21, 2005) (applying the burden shifting approach in a case “evaluating transactions between the corporation and a third party when the directors of the corporation (and the affiliates of such directors) own significant non-majority stakes of the corporation’s voting shares

The court correctly noted that a special committee did not automatically eliminate the interested influence but incorrectly limited the observation to a controlling shareholder.⁷⁵ The same rationale can also apply in the case of an “imperial” CEO.⁷⁶ Moreover, even if a controlling shareholder somehow presented a greater risk of influence, that would not automatically justify a lower standard for interested directors. The opaqueness of the reasoning has caused at least one court to question the approach.⁷⁷ In fact, the distinction is probably not analytical but historical.⁷⁸

4. *Summary.*—The courts have never provided an adequate justification for applying the business judgment rule to a conflict of interest transaction approved by a board that contains a majority of independent directors. Section 144(a) does not, as some courts have suggested, compel applying the outcome. Nor does it result from expungement of the conflict. In fact, the approach makes no effort to ensure that a decision-making process is free of the conflict of interest.⁷⁹ The result is to use the business judgment

and have personal interests that significantly diverge from those of other equity holders” involving significant non-majority stakes (footnote omitted)). Commentators have criticized the view that transactions with controlling shareholders are inherently coercive or susceptible to retaliation. See Peter V. Letsou & Steven M. Haas, *The Dilemma That Should Never Have Been: Minority Freeze Outs in Delaware*, 61 BUS. LAW. 25 (2005).

75 As a structural matter, courts have expressed a preference for a multi-member committee. See *Gesoff v. IIC Indus.*, 902 A.2d 1130, 1146 (Del. Ch. 2006) (“The court necessarily places more trust in a multiple-member committee than a committee where a single member works free of the oversight provided by at least one colleague.” (footnote omitted)).

76 Eisner’s control of the Disney board is a good example. See discussion *infra* Part V.

77 See *In re Cox Commc’ns, Inc., S’holders Litig.*, 879 A.2d 604; see also Allen, Jacobs & Strine, Jr., *supra* note 67, at 1307 (“Also strained is the rationale for not giving full ratification effect to approval by a genuinely effective special committee of independent directors.”).

78 The courts addressed the impact of independent decision making in *Weinberger*, a case decided in 1983. See generally, *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983). In that opinion, the court largely locked itself into the view that the use of an independent committee did not result in the application of the business judgment rule. See *id.* at 709 n.7 (“Particularly in a parent-subsidiary context, a showing that the action taken was as though each of the contending parties had in fact exerted its bargaining power against the other at arm’s length is strong evidence that the transaction meets the test of fairness.” (citations omitted)); see also *Rosenblatt v. Getty Oil Co.*, 493 A.2d 929, 937 (Del. 1985) (“However, approval of a merger, as here, by an informed vote of a majority of the minority shareholders, while not a legal prerequisite, shifts the burden of proving the unfairness of the merger entirely to the plaintiffs.” (citation omitted)). Thus, the doctrine was largely fixed in the 1980s. It was not until the 1990s that the Delaware courts conclusively found that approval by independent directors results in the application of the business judgment rule. See *supra* notes 46, 47. By then, however, the court was stuck with a different position with respect to controlling shareholders.

79 The court in *Aronson* noted the arbitrary nature of the majority requirement. See *Aronson v. Lewis*, 473 A.2d 805, 815 n.8 (Del. 1984) (“We recognize that drawing the line at a majority of the board may be an arguably arbitrary dividing point. Critics will charge that we are ignoring the structural bias common to corporate boards throughout America, as well as the other unseen socialization processes cutting against independent discussion and deci-

rule to insulate the board from challenges to actions motivated not by risk-taking but by a desire to benefit an interested party.

III. INDEPENDENCE AND THE BOARD

A. *Independence Defined*

That disinterested approval will somehow protect the corporation from the risks of self-dealing has been labeled by some as an abject failure.⁸⁰ Early cases suggested that disinterested approval was an impossible goal.⁸¹ Because of human nature, directors may find it impossible to act in a truly unbiased fashion when considering transactions that benefit their brethren on the board.⁸²

Even assuming that disinterested approval is attainable, however, the approach presumes a rigorous attempt to ensure that those making the decision are in fact independent. Independence requires that decisions be “based on the corporate merits of the subject . . . rather than extraneous considerations or influences.”⁸³ In other words, “the end result . . . must be that each director has brought his or her own informed business judgment

sionmaking in the boardroom. The difficulty with structural bias in a demand futile case is simply one of establishing it in the complaint for purposes of Rule 23.1. We are satisfied that discretionary review by the Court of Chancery of complaints alleging specific facts pointing to bias on a particular board will be sufficient for determining demand futility.”), *overruled in part by* *Brehm v. Eisner*, 746 A.2d 244 (Del. 2000). *Aronson* was a demand excusal case. There, the requirement of a majority of independent directors meant that the board would have sufficient persons who could manage and make decisions about the litigation. The same reasoning does not apply, however, to the approval of conflict of interest transactions. There is no need to “manage” the transaction. The only issue is whether approval was neutral and therefore free of the interested taint. The majority requirement does not ensure this.

80 *See* Marsh, *supra* note 9, at 54 (“[I]t can be asserted with some assurance that the requirement of approval by a disinterested majority of the board of directors was an abject failure.”). Others have noted the practical difficulty in determining independence. *See* Donald C. Clarke, *Setting the Record Straight: Three Concepts of the Independent Director*, 32 DEL. J. CORP. L. (forthcoming 2006) (manuscript at 28, available at <http://ssrn.com/abstract=892037>) (“The second issue is that of effectiveness. Here the question is whether, given the many and subtle ties that may exist between nominees and company management, independence can really be ascertained in the abstract on the basis of paper submissions by management, and whether independence so ascertained is really very meaningful.”).

81 Later cases have suggested that as well. *See, e.g.* *Bergstein v. Tex. Int’l Co.*, 453 A.2d 467, 470 (Del. Ch. 1982) (“The Second U.S. Circuit Court of Appeals has expressed the opinion that a director who maintains a working relationship with other directors can never be truly independent.” (citation omitted)).

82 *See* Gelb, *supra* note 35, at 135 (“Yet, even the platonic disinterested or independent director may lack the intelligence, courage, desire, time, character, communicative skill, or knowledge to carefully scrutinize, stand against, or influence others with respect to self-dealing transactions.”).

83 *Aronson*, 473 A.2d at 816.

to bear with specificity upon the corporate merits of the issues without regard for or succumbing to influences which convert an otherwise valid business decision into a faithless act.”⁸⁴

Although broadly stated, the test has been applied in an excessively narrow and often inconsistent fashion. Resolution turns almost exclusively on control. Directors under the domination of an interested director will not be treated as independent.⁸⁵ Yet, control has not engendered a broad, holistic examination of the relationships among directors. Instead, it has meant little more than the possible loss of a material stream of income,⁸⁶ with other types of non-motivations receiving little consideration.⁸⁷

B. Materiality

Independence is lost most readily through financial leverage when the interested party can terminate a material stream of income.⁸⁸ In defining “material,” courts eschew an objective formulation⁸⁹ and instead rely on a subjective, actual person standard,⁹⁰ one that requires an “independent

84 *Id.*

85 *See Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1156, 1170 n.25 (Del. 1995) (“A majority of disinterested directors is not “independent” if that majority was dominated by an interested director.” (citation omitted)).

86 Although the Delaware Supreme Court has belatedly recognized friendship as another possible basis for loss of independence, the test will not result in serious examination of the relationships as a possible source of bias. *See infra* notes 142–48 and accompanying text.

87 *See infra* note 137 and accompanying text. Thus, for example, facts tending to show that directors often sided with the interested party will not suffice. *See Khanna v. McMinn*, No. 20545-NC, 2006 Del. Ch. LEXIS 86, at *58 n.92 (Del. Ch. May 9, 2006) (“Although there may be instances in which a director’s voting history would be sufficient to negate a director’s presumed independence, routine consensus cannot suffice to demonstrate disloyalty on the part of a director.”).

88 Some courts have required that the power to terminate a material income stream be unilateral. *See Benihana of Tokyo, Inc. v. Benihana, Inc.*, 891 A.2d 150, 177 (Del. Ch. 2005) (“This Court will not find a director beholden unless the purported controlling person has ‘unilateral’ power to substantially affect the director.” (footnote omitted)), *aff’d*, 906 A.2d 114 (Del. 2006). The decisions in this area have not, however, been consistent. *See Ales v. Blasband*, 634 A.2d 927, 937 (Del. 1993) (“Although Sherman’s continued employment and substantial remuneration may not hinge solely on his relationship with the Rales brothers, there is little doubt that Steven Rales’s position as Chairman of the Board of Danaher and Mitchell Rales’s position as Chairman of its Executive Committee place them in a position to exert considerable influence over Sherman.”). The need for unilateral authority is a rote approach that completely ignores the probable influence of someone in a position of authority.

89 *See Cinerama*, 663 A.2d at 1167; *see also Orman v. Cullman*, 794 A.2d 5, 24 (Del. Ch. 2002) (“[T]he Delaware Supreme Court has rejected an objective ‘reasonable director’ test and instead requires the application of a subjective ‘actual person’ standard to determine whether a particular director’s interest is material and debilitating . . .” (footnote omitted)).

90 *Cinerama*, 663 A.2d at 1167 (“The Court of Chancery reasoned that the logical alternative was a subjective “actual person” standard. We agree. The subjective standard is consistent with this Court’s observation, in *Cede II*, that requiring a shareholder plaintiff to show ‘the

judicial determination regarding the materiality of the ‘*given*’ director’s self-interest.”⁹¹

Whatever the wisdom of the approach, a subjective standard has considerable practical implications. To show materiality, plaintiffs must establish the unique financial circumstances of each director. Logically, very wealthy directors would almost always be independent, with most income streams immaterial. Conversely, those of very modest means would lose their independence upon receipt of any significant payment, including directors’ fees.

In fact, the courts have not applied the materiality analysis in a consistent fashion. The courts have used the subjective standard almost exclusively to broaden, rather than narrow, the category of directors considered independent, routinely finding significant streams of income immaterial. Ordinary directors’ fees do not result in a loss of independence, despite modest income or net worth.⁹²

Materiality cases fall into two broad categories: direct and indirect payments. Direct payments are those made to the director, including salaries, fees, and payments under consulting or other agreements. Indirect payments are those made to another entity—including clients, suppliers, or charities—in which the director has a position of control or otherwise benefits from the payments.

1. Direct payments.—With respect to employee salaries, courts generally “assume” materiality⁹³ because of the traditional importance of the relationship.⁹⁴ The courts have, however, created exceptions without much

materiality of a director’s self-interest to the *given* director’s independence’ was a ‘restatement of established Delaware law.’” (citation omitted)).

⁹¹ *Id.* at 1167.

⁹² *See infra* notes 103–10 and accompanying text.

⁹³ Official Comm. of Unsecured Creditors of Integrated Health Servs. v. Elkins, No. 20228-NC, 2004 Del. Ch. LEXIS 122, at *42 (Del. Ch. Aug. 24, 2004) (“Although the Complaint does not allege that Silverman’s position [as CEO of a subsidiary] was material to his financial well-being or that Silverman served at Elkins’s pleasure, I will assume, without deciding, that he lacked independence from Elkins.”); *see also* Rales v. Blasband, 634 A.2d 927, 937 (Del. 1993) (“Because of their alleged substantial financial interest in maintaining their employment positions, there is a reasonable doubt that these two directors are able to consider impartially an action that is contrary to the interests of the Rales brothers.”); Zimmerman v. Braddock, No. 18473-NC, 2005 Del. Ch. LEXIS 135, at *44 (Del. Ch. Sept. 8, 2005) (CEO “handsomely compensated”), *rev’d*, 906 A.2d 776 (Del. 2006); *In re* The Ltd., Inc. S’holders Litig., No. 17148-NC, 2002 Del. Ch. LEXIS 28, *21 (Del. Ch. Mar. 27, 2002) (“It is reasonable to infer that compensation of this magnitude [\$1.8 million a year] is material to him.”).

⁹⁴ *See* Friedman v. Beningson, No. 12232, 1995 Del. Ch. LEXIS 154 (Del. Ch. Dec. 4, 1995); *see also* Cal. Pub. Employees’ Ret. Sys. v. Coulter, No. 19191, 2002 Del. Ch. LEXIS 144, at *32 (Del. Ch. Dec. 18, 2002) (“Coulter’s position as White’s superior alone would be sufficiently material to give reason to doubt White’s independence from Coulter.”); *In re* The Ltd., Inc. S’holders Litig., 2002 Del. Ch. 28, at *20–23.

analysis. Thus, a director receiving a “substantial salary”⁹⁵ did not lose his independence where he also owned a sizable block of stock. The court made the determination without discussing the salary, the number of shares actually owned⁹⁶ or the impact of the decision on share prices.⁹⁷

Payments made pursuant to consulting agreements are treated with less consistency than salaries. One court considered consulting fees equal to twenty-two percent of a director’s annual salary material, particularly when coupled with fees.⁹⁸ Other courts treated large payments (\$75,000⁹⁹ and \$150,000¹⁰⁰) as material even without proof of the director’s income.¹⁰¹ At the same time, courts have held similar amounts to be immaterial.¹⁰²

95 According to the proxy statement for the February 1998 meeting, Roy Disney was paid \$500,000 in salary and \$700,000 in bonus. *See* WALT DISNEY CO., PROXY STATEMENT 15 (1998).

96 The court reported the total number owned by the entire Disney family. *See infra* note 201. The number of shares actually owned by Roy Disney was less, a number apparently available to the court. *See* WALT DISNEY CO., PROXY STATEMENT, 2 (1998).

97 As the court concluded, “[t]he only reasonable inference that I can draw . . . is that he is an economically rational individual whose priority is to protect the value of his Disney shares, not someone who would intentionally risk his own and his family’s interests in order to placate Eisner.” *In re* The Walt Disney Co. Derivative Litig., 731 A.2d 342, 356 (Del. Ch. 1998), *aff’d in part, rev’d in part sub nom.* Brehm v. Eisner, 746 A.2d 244 (Del. 2000). The “only reasonable inference” apparently meant that Roy Disney valued some slight shift in share prices resulting from the overpayment to Ovitz more than his “substantial salary.” Remarkably, the court was able to determine this without any quantification of the consequences or allowing plaintiff any discovery on the issue.

98 *In re* Emerging Commc’ns, Inc. S’holders Litig., No. 16415, 2004 Del. Ch. LEXIS 70, at *123-24 (Del. Ch. May 3, 2004). The payments were on top of the \$30,000 paid in directors fees. *Id.*

99 Orman v. Cullman, 794 A.2d 5, 30 (Del. Ch. 2002) (“Even though there is no bright-line dollar amount at which consulting fees received by a director become material, . . . I think it is reasonable to infer that \$75,000 would be material . . .”).

100 *In re* The Ltd., Inc., S’holders Litig. No. 17148-NC, 2002 Del. Ch. LEXIS 28, at *23 (Del. Ch. Mar. 27, 2002) (“I am satisfied that it is reasonable to infer from these allegations that continued annual compensation [in the form of consulting fees] in excess of \$150,000 would be material . . .”); *see also* Kahn v. Tremont Corp., 694 A.2d 422, 430 (Del. 1997) (finding that director was not independent where three years before he had received \$10,000 per month and more than \$325,000 in bonuses).

101 *See In re Emerging Commc’ns, Inc. S’holders Litig.*, 2004 Del. Ch. LEXIS 70 at *125 (“As of mid-1997, Muoio was on an annual \$200,000 retainer for providing banking/financial advisory services, and he viewed Prosser as a source of additional future lucrative consulting fees.” (citations omitted)); *see also* Krasner v. Moffett, 826 A.2d 277, 283 (Del. 2003) (“Latiolais and Wohleber allegedly received substantial income from other entities within the interlocking directorates of Freeport-McMoRan companies and arguably had an interest in appeasing the MOXY and FSC insiders who also served with Latiolais and Wohleber on the boards of other Freeport companies.” (footnote omitted)); *In re* Ply Gem Indus., Inc. S’holders Litig., No. 15779-NC, 2001 Del. Ch. LEXIS 84, at *33-34 (Del. Ch. June 26, 2001) (holding that reasonable basis exists to question a director’s independence when that director receives \$91,000 in consulting fees).

102 *See* White v. Panic, 783 A.2d 543, 552 n.24 (Del. 2001) (finding that consulting fees

The rule for ordinary directors' fees is categorical; they are not material.¹⁰³ In effect, courts ignore their own standard of subjective materiality and replace it with a mandatory rule holding that "usual and customary"¹⁰⁴ fees will not impair a director's neutrality.¹⁰⁵ This is true irrespective of the actual amount paid, which can be considerable,¹⁰⁶ or the net worth of the particular director involved.¹⁰⁷ Nor, as a practical matter, do the courts

of \$75,000 and \$50,000 did not result in a loss of independence); *Highland Legacy Ltd. v. Singer*, No. 1566-N, 2006 Del. Ch. LEXIS 55, at *22–23 (Del. Ch. Mar. 17, 2006) (noting fee of \$10,000 per month; "Moreover, the complaint does not even allege that these fees were unusually large or material to Goldsmith or Steele." (footnote omitted)); *In re The Walt Disney Co. Derivative Litig.*, 731 A.2d at 360 (holding that director receiving \$50,000 in consulting fees did not lose independence), *aff'd in part, rev'd in part sub nom.* *Brehm v. Eisner*, 746 A.2d 244 (Del. 2000).

103 *Grobow v. Perot*, 539 A.2d 180, 188 (Del. 1988), *overruled in part by Brehm v. Eisner*, 746 A.2d 244 (Del. 2000); *In re The Ltd., Inc. S'holders Litig.*, 2002 Del. Ch. LEXIS 28 at *17; *see also* *A.R. Demarco Enters. v. Ocean Spray Cranberries, Inc.*, No. 19133-NC, 2002 Del. Ch. LEXIS 135, at *17 (Del. Ch. Nov. 26, 2002) ("It is well established in Delaware law that ordinary director compensation alone is not enough to show demand futility." (footnote omitted)); *Orman*, 794 A.2d at 29 n.62. *But see In re Gen. Motors (Hughes) S'holder Litig.*, No. 20269, 2005 Del. Ch. LEXIS 65, at *6 n.7 (Del. Ch. May 4, 2005) ("The Complaint does allege that Pfeiffer and Bryan are "professional directors" and that they derive "substantial income" from serving on various boards of directors, but the Complaint does not allege that the income received from GM is material to them." (citation omitted)), *aff'd*, 897 A.2d 162 (Del. 2006).

104 *In re Nat'l Auto Credit, Inc. S'holders Litig.*, No. 19028, 2003 Del. Ch. LEXIS 5, at *39 (Del. Ch. Jan. 10, 2003).

105 *See id.* at *39–40. This is true whether the fees are from the parent or a subsidiary. *See In re The Ltd., Inc. S'holders Litig.*, 2002 Del. Ch. LEXIS 28 at *18–19 ("Similarly, the receipt of director's fees from a subsidiary does not, in the absence of other facts suggesting a lack of independence, demonstrate a reasonable doubt as to that director's loyalty." (footnote omitted)).

106 *See In re Gen. Motors (Hughes) S'holder Litig.*, 2005 Del. Ch. LEXIS 65, at *5 n.5 (noting that directors paid annual retainer of \$200,000 per year, reimbursement for travel expenses, and other compensation valued by plaintiffs at \$17,000 per year; chair of audit committee receives an annual retainer of \$30,000 per year; committee's other members receive an annual retainer of \$20,000 per year); Ted Pincus, *Bank One, J.P. Morgan Name & Members Each to New Board*, CHI. SUN-TIMES, May 4, 2004, at 59 ("They will be paid what J.P. Morgan Chase directors are currently paid: a minimum of \$75,000 annually, plus a grant of stock worth \$170,000 the day of the grant. Directors who are chairmen of special committees receive an additional \$15,000 a year."); *Id.* ("Bank One directors are paid a minimum \$60,000 annual retainer plus stock grants worth at least \$60,000 to non-employees, according to a regulatory filing last month."). For a discussion of the fees paid to directors in the Fortune 100, *see SHEARMAN & STERLING LLP*, 2005 TRENDS IN THE CORPORATE GOVERNANCE PRACTICES OF THE LARGEST 100 COMPANIES, 6 (2006), http://www.shearman.com/files/Publication/d64b2717-9450-423e-8926-0c34bfe811f5/Presentation/PublicationAttachment/635223a5-139f-45f1-b5de-1124bb35de67/CG_survey_2005.pdf.

107 Thus, the principal of the elementary school in *Disney* was held to be independent despite the likely materiality of the fees. *See In re The Walt Disney Co. Derivative Litig.*, 731 A.2d at 359–60. The analytically inconsistent approach has caused courts to consider other methods of rendering fees irrelevant. A number of recent cases have concluded that it does not matter even if the fees are material because an interested director lacks the unilateral author-

examine fees in conjunction with other payments.¹⁰⁸ Only where the payments climbed to astronomical levels¹⁰⁹ or were increased as a quid pro quo¹¹⁰ were they found to impair independence.

Courts have justified the rule concerning fees by asserting that to do otherwise would result in all directors being “deemed biased”¹¹¹ or would allow only wealthy individuals to sit on the board.¹¹² Neither explanation

ity to dismiss an independent director, emphasizing that nominations are done by committee and approved by shareholders. *See In re J.P. Morgan Chase & Co. S’holder Litig.*, 906 A.2d 808, 821 (Del. Ch. 2005), *aff’d sub nom.* *J.P. Morgan Chase & Co. S’holder Litig. v. Harrison*, 906 A.2d 766 (Del. 2006) (“Harrison cannot fire any of [the directors]. Additionally, Harrison is not a controlling stockholder of JPMC and therefore has no power to oust them as directors through a stockholder vote. On the contrary, it is the eleven outside directors who collectively have the power to dismiss Harrison and the rest of his management team.”); *Jacobs v. Yang*, No. 206-N, 2004 Del. Ch. LEXIS 117, at *16 (Del. Ch. Aug. 2, 2004), *aff’d*, 2005 Del. LEXIS 38 (Del. Jan. 21, 2005) (“In addition, the board has a nominating committee comprised of non-employee directors who recommend board candidates. The nominating committee ensures that the Insider Defendants (particularly Yang) are incapable of controlling a director’s nomination, election and continued tenure on Yahoo!’s board.”). The approach, of course, ignores the traditional degree of control held by a CEO over board membership. *See In re The Walt Disney Co. Derivative Litig.*, 907 A.2d 693, 706–61 (Del. Ch. 2005), *aff’d sub nom.* *Brehm v. Eisner* 906 A.2d 27 (Del. 2006) (“Eisner stacked his (and I intentionally write ‘his’ as opposed to ‘the Company’s’) board of directors with friends and other acquaintances who, though not necessarily beholden to him in a legal sense, were certainly more willing to accede to his wishes and support him unconditionally than truly independent directors.” (footnote omitted)); *Citron v. Fairchild Camera Instrument Corp.*, 569 A.2d 53, 58 (Del. 1989) (noting that director who earned CEO’s “displeasure” was not renominated).

108 Thus, in *In re The Ltd., Inc. S’holders Litig.*, 2002 Del. Ch. LEXIS 28, at *18–19, the director apparently received fees for sitting on the board of the parent and on a subsidiary. The court examined each in isolation and determined that fees alone were insufficient to result in control. *But see In re Emerging Commc’ns, Inc., S’holders Litig.*, No. 16415, 2004 Del. Ch. LEXIS 70, at *126–27 (Del. Ch. May 3, 2004) (“That expectation [to continue as directors], coupled with the fact that his director and committee fees represented a sizeable portion of his income, was sufficient to vitiate Vondras’ independence for purposes of considering objectively whether the Privatization was fair to the minority stockholders.”).

109 *See In re eBay S’holders Litig.*, No. 19988-NC, 2004 Del. Ch. LEXIS 4, at *11 (Del. Ch. Feb. 11, 2004) (“Given that the value of the options for Cook (and allegedly for the other outside directors) potentially run into the millions of dollars, one cannot conclude realistically that Cook would be able to objectively and impartially consider a demand to bring litigation against those to whom he is beholden for his current position and future position on eBay’s board.”).

110 *See In re Nat’l Auto Credit, Inc., S’holders Litig.* 2003 Del. Ch. LEXIS 5, at *40 (“It is not that the Directors’ Fees are large amount paid on a regular basis; rather, the Directors’ Fees were the product of massive increases which reasonably can be inferred to have been granted in return for the Defendant Directors’ support . . .”).

111 *Id.* at *38; *see also Grobow v. Perot*, 526 A.2d 914, 923 n.12 (Del. Ch. 1987), *aff’d*, 539 A.2d 180 (Del. 1988).

112 *In re The Walt Disney Co. Derivative Litig.*, 731 A.2d 342, 359 (Del. Ch. 1998) (“Furthermore, to do so would be to discourage the membership on corporate boards of people of less-than extraordinary means. Such “regular folks” would face allegations of being dominated by other board members, merely because of the relatively substantial compensa-

supports this position. Both ignore the impact of the fees on the director's decision-making process, the very purpose of the materiality test. Moreover, these explanations would not prohibit anyone from sitting on the board, only from qualifying as independent. The approach essentially concedes that the fees will sometimes be material and affect the decision-making process, but should be ignored for questionable policy reasons.

2. *Indirect Payments.*—Indirect payments involve funds paid to another entity, whether a corporation, partnership or limited liability company, where the director has a position of control or otherwise benefits economically. Independence will be impaired when the payments are material to the supplier, vendor, customer, or director.¹¹³

Establishing materiality of the payments to the director is often difficult. Materiality may be inferred where the payments are large relative to the size of the firm and the director is a principal or owner.¹¹⁴ Otherwise, plaintiffs must show a relationship between the payments and the director's compensation.¹¹⁵ Given the absence of public information on compensation formulas, this can be difficult if not impossible.¹¹⁶ For example,

tion provided by the board membership compared to their outside salaries. I am especially unwilling to facilitate such a result.”), *aff'd in part, rev'd in part sub nom.* Brehm v. Eisner, 746 A.2d 244 (Del. 2000).

113 See *Khanna v. McMinn*, No. 20545-NC, 2006 Del. Ch. LEXIS 86, at *59 (Del. Ch. May 9, 2006) (noting that the test is whether payments to vendor were material to the vendor or material to the director).

114 See *Zimmerman v. Braddock*, No. 18473-NC, 2005 Del. Ch. LEXIS 135, at *43 n.95 (Del. Ch. Sept. 8, 2005) (noting that company was one of two largest clients, with five year contract involving minimum payments of \$5 million), *rev'd*, 906 A.2d 776 (Del. 2006). Many of these cases involve payments to law firms. See *In re Emerging Commc'ns, Inc. S'holders Litig.*, No. 16415, 2004 Del. Ch. LEXIS 70, at *121 (Del. Ch. May 3, 2004) (finding that company's payments constituted most of law firm's revenues).

115 See *In re Compucom Sys., Inc. S'holders Litig.*, No. 499-N, 2005 Del. Ch. LEXIS 145, at *37 (Del. Ch. Sept. 29, 2005) (“The plaintiff does not allege what compensation Loewenberg and/or JDL Enterprises obtained for Loewenberg's advisory services, nor does the complaint allege that such fees constituted such a large part of his or the firm's income so as to be material to Loewenberg or JDL Enterprises.”); *Zimmerman*, 2005 Del. Ch. LEXIS 135, at *42–43 (finding that director was not independent where company was the second largest customer of business where he served as CEO); see also *In re J.P. Morgan Chase & Co. S'holder Litig.*, 906 A.2d 808, 814–16 (Del. Ch. 2005), *aff'd sub nom.* J.P. Morgan Chase & Co. S'holder Litig. v. Harrison, 906 A.2d 766 (Del. 2006) (noting that directors were connected to companies that used services of bank). Allegations of materiality are not enough. See *Jacobs v. Yang*, No. 206-N, 2004 Del. Ch. LEXIS 117, at *24 (Del. Ch. Aug. 2, 2004) (“Merely stating that the agreements between Yahoo! and AMG are ‘crucial to AMG's continued viability’ is not enough.”).

116 In *Disney*, Senator Mitchell was special counsel to a law firm used by the company. The court noted the absence of facts showing how Mitchell benefited from the fees. *In re Walt Disney Co. Derivative Litig.*, 731 A.2d at 360. To provide the requisite information, the plaintiff presumably would have needed to know the allocation formula within the law firm, not something likely to be public.

a director who was also a principal of a business receiving \$400,000 a year from the company did not lose his independence absent evidence of the materiality of the payment.¹¹⁷

The same is true in the case of interlocking directors.¹¹⁸ In *Khanna v. McMinn*,¹¹⁹ a director sat on the board of Covad Communication Group and on the board of a vendor receiving \$2.2 million in revenue from Covad. The court dismissed the independence challenge, concluding that the plaintiff had not produced facts sufficient to show the materiality of the payment to the vendor or director.

The Court cannot discern whether the revenue . . . is material to either [the vendor] or to [the director] because of his relationship with [the vendor]. Neither the terms of [the vendor's] relationship with Covad (*e.g.*, whether the companies have entered into a long-term contract), nor particularized facts supporting the Plaintiffs' conclusory statement in their brief that [the vendor's] business . . . could be "taken away" . . . are provided. Moreover, no allegation has been made that [the director's] responsibilities to [the vendor] include managing the firm's relationship with Covad; nor could the Court conclude that [the director] has a financial interest in [the vendor], other than possibly an unspecified director's salary, which might influence his decisions.¹²⁰

Having presented evidence of a disqualifying relationship, the court refused to allow discovery to explore the facts surrounding the relationship.¹²¹

117 *In re The Ltd., Inc. Sec. Litig.*, No. 17148-NC, 2002 Del. Ch. LEXIS 28, at *19 (Del. Ch. Mar. 27, 2002) ("The Complaint is devoid of any allegations asserting (or from which an inference can reasonably be drawn, for that matter) that the \$400,000 annual revenue that Audio receives from its dealings with The Limited and its affiliates was material to Audio's business. Moreover, the Complaint does not allege how Kollat, as "a principal," may have benefited from any portion of those revenues. Accordingly, the plaintiffs have also failed to plead particularized facts raising a reasonable doubt as to Kollat's independence.").

118 *In re W. Nat'l Corp. S'holders Litig.*, No. 15927, 2000 Del. Ch. LEXIS 82, at *63 (Del. Ch. May 22, 2000) ("Here, plaintiffs have not proffered any additional evidence that the banking relationship between Chase Texas and American General sterilized Buckwalter's discretion or subverted his good faith evaluation of the merger's underlying corporate merits."); *see also Kaplan v. Wyatt*, 499 A.2d 1184, 1189 (Del. 1985) (finding a director who was an affiliate of a number of companies with which the nominal corporate defendant transacted sufficient business to be independent). One court suggested that any traditional lending relationship would not be enough. *See In re J.P. Morgan Chase & Co. S'holder Litig.*, 906 A.2d at 822 ("JPMC is a national commercial and investment bank. That it provided financing to large American companies should come as no shock to anyone. Yet this is all that the plaintiffs allege.").

119 *Khanna v. McMinn*, No. 20545-NC, 2006 Del. Ch. LEXIS 86, at *7 (Del. Ch. May 9, 2006).

120 *Id.* at *65–66 (footnotes omitted).

121 While reiterating the strict pleading requirements, the court acknowledged but ignored the Catch 22 that the required information was otherwise unavailable from public sources, effectively making the pleading requirement impossible to meet. *Id.* at *89 n.163

Even where the payment is otherwise material, courts have sometimes required proof of actual influence. In *Kaplan v. Wyatt*, for example, the plaintiff filed a derivative suit against, among others, Oscar Wyatt: the CEO, Chairman, and founder of Coastal Corporation.¹²² In response, the board formed a special committee consisting of two directors. One of them, J. Howard Marshall, owned interests in other companies doing business with Coastal.¹²³ In dismissing the challenge to Marshall's independence, the court ignored the multitude of business connections and instead required evidence that "Marshall's business affiliations influence[d] his decisions relating to Coastal."¹²⁴

3. *Indirect Payments and Non-Profits.*—Directors frequently serve in positions of authority with non-profit organizations.¹²⁵ As a general matter, they do not lose their independence even where the company or its employees make significant contributions to the charity, despite the obvious potential for influence. Courts use a variety of mechanisms to achieve this result. They typically require that the director receive a direct benefit from the contributions, or that the director has actually been influenced by the payments.¹²⁶

("The Court notes that the factual paucity described above may have resulted from difficulties in accessing certain information. Indeed, even after using the "tools at hand" to develop particularized facts (*e.g.*, public filings and § 220), certain information may be restricted due to the fact that it is held by entities with no public disclosure obligations. Although the burdens presented by such obstacles have been recognized, the pleading standard under which the Court examines allegations for requisite particularity remains unaltered, even for plaintiffs who employed the "tools at hand." (citation omitted)); *see also* Brehm v. Eisner, 746 A.2d 244, 268 (Del. 2000) (Hartnett, J., concurring) ("Plaintiffs must not be held to a too-high standard of pleading because they face an almost impossible burden when they must plead facts with particularity and the facts are not public knowledge.").

¹²² *Kaplan*, 499 A.2d at 1186.

¹²³ He and members of his family owned two percent of Koch Industries (Koch), a company that did business with Coastal. One year, the business between the two companies was \$266 million. The court noted that this was less than two percent of Koch's sales. In addition to the oil sales, Koch sold Coastal an oil tanker. *Id.* at 1187. He owned fifty percent of the shares of Petroleum Corporation (Petco), which engaged in ventures with subsidiaries of Coastal. The ventures "contributed large amounts of money to Petco's programs." *Id.*

¹²⁴ *Id.* at 1189; *see also In re J.P. Morgan Chase & Co. S'holder Litig.*, 906 A.2d 808, 822 (Del. Ch. 2005) ("JPMC is a national commercial and investment bank. That it provided financing to large American companies should come as no shock to anyone. Yet this is all that the plaintiffs allege.").

¹²⁵ One study of the top 100 largest companies indicated that a majority of the companies have directors who are officers of non-profit organizations. *See* SHEARMAN & STERLING, LLP, *supra* note 106, at 10 (fifty-six percent with directors who also serve as officers; thirty percent who serve as directors of a non-profit; twenty-seven percent who serve as a trustee of a nonprofit; eleven percent who serve as employees of a non-profit; and two percent who are "affiliated" with a non-profit).

¹²⁶ *See In re The Walt Disney Co. Derivative Litig.*, 731 A.2d 342, 359 (Del. Ch. 1998)

In *J.P. Morgan*,¹²⁷ for example, a director also served as the president and a trustee for the American Museum of Natural History.¹²⁸ The plaintiffs challenged the director's independence by asserting that J.P. Morgan Chase (JPMC) was a significant benefactor of the Museum.¹²⁹ The two institutions also had a long history, with J. Pierpont Morgan having been one of the Museum's earliest supporters.¹³⁰ The court discounted the relationship, faulting the complaint for failing to show "any potential influence" resulting from the contributions. "The plaintiffs state that JPMC is a significant benefactor, but they never state how JPMC's contributions could, or did, affect the decision-making process of the president of one of the largest museums in the nation."¹³¹

The case essentially ignored the influence inherent in large contributions. Even if not quantitatively material, non-profits have an incentive to maintain funding sources.¹³² Contributions on the margin may make the difference in the success of a non-profit's mission or the ability to continue a particularly important program. Executive directors may receive psychic benefits by ensuring the success of a cause they believe in; their pay, to the extent that it is performance-based, may be affected by continued success in fund raising.

Imposing an obligation to show actual influence as a result of the gift ignores these effects. The court also failed to explain how such an "effect" could be demonstrated, particularly given that evidence of director voting patterns typically receives little probative weight in the independence

(Eisner made \$1 million contribution to university run by director; director independent because he did not benefit directly from contribution), *aff'd in part, rev'd in part sub nom. Brehm v. Eisner*, 746 A.2d 244 (Del. 2000); *see also In re Gen. Motors (Hughes) S'holder Litig.*, No. 20269, 2005 Del. Ch. LEXIS 65, at *34 (Del. Ch. May 4, 2005) ("Missing, however, is any allegation that this contribution conferred a material benefit on Ward at the expense of the Corporation or its Shareholders."), *aff'd*, 897 A.2d 162 (Del. 2006).

127 *See In re J.P. Morgan Chase & Co. S'holder Litig.*, 906 A.2d at 822 ("The plaintiffs state that JPMC is a significant benefactor, but they never state how JPMC's contributions could, or did, affect the decision-making process of the president of one of the largest museums in the nation.")

128 *Id.* at 814.

129 *Id.* at 822.

130 American Museum of Natural History, Timeline, *available at* http://www.amnh.org/museum/history/?src=pv_h.

131 *In re J.P. Morgan Chase & Co. S'holder Litig.*, 906 A.2d at 822.

132 *See generally* Melvin Aron Eisenberg, *Corporate Conduct that Does not Maximize Shareholder Gain: Legal Conduct, Ethical Conduct, the Penumbra Effect, Reciprocity, the Prisoner's Dilemma, Sheep's Clothing, Social Conduct, and Disclosure*, 28 STETSON L. REV. 1 (1998); Faith Stevelman Kahn, *Foreword: Law, Culture, Education, and Politics*, 41 N.Y.L. SCH. L. REV. 753 (1997); Faith Stevelman Kahn, *Pandora's Box: Managerial Discretion and the Problem of Corporate Philanthropy*, 44 UCLA L. REV. 579 (1997).

analysis.¹³³ The standard, therefore, is an extraordinarily difficult one to meet, particularly absent any right to discovery.

C. *Non-Pecuniary Relationships*

1. *Non-Development*.—*Aronson* broadly defined “independent” as a decision on the merits, unaffected by “extraneous considerations or influences.”¹³⁴ Nothing in *Aronson* limited the notion of “extraneous considerations” to pecuniary benefits. Nonetheless, for the two decades following the decision, courts did exactly that. Other than some family relationships,¹³⁵ courts treated personal and outside business relationships as irrelevant to the analysis of independence.¹³⁶ The same was true of other potentially bias-

133 See *Khanna v. McMinn*, No. 20545-NC, 2006 Del. Ch. LEXIS 86, at *58 n.92 (Del. Ch. May 9, 2006) (“Although there may be instances in which a director’s voting history would be sufficient to negate a director’s presumed independence, routine consensus cannot suffice to demonstrate disloyalty on the part of a director. To conclude otherwise would simply encourage staged disagreements and nonunanimous decisions for the sake of nonunanimous decisions in the boardroom.”); see also *Kohls v. Duthie*, 791 A.2d 772, 781 (Del. Ch. 2000) (discounting allegations that “dominated” director voted on transaction beneficial to CEO; “More importantly, Christenson, an outside director, was simply one of a unanimous board (other than Lerdal) to approve the transaction.”).

134 *Aronson v. Lewis*, 473 A.2d 805, 816 (Del. 1984), *overruled in part by Brehm v. Eisner*, 746 A.2d 244 (Del. 2000).

135 See *In re The Ltd., Inc. S’holders Litig.*, No. 17148-NC, 2002 Del. Ch. LEXIS 28, at *13 (Del. Ch. Mar. 27, 2002) (noting that wife stood to benefit from transaction that aided spouse). Even on this point, however, the courts have been inconsistent. See *In re Oracle Corp. Derivative Litig.*, 824 A.2d 917, 939 (Del. Ch. 2003) (“Without backtracking from these general propositions, it would be less than candid if I did not admit that Delaware courts have applied these general standards in a manner that has been less than wholly consistent. Different decisions take a different view about the bias-producing potential of family relationships, not all of which can be explained by mere degrees of consanguinity.”). For the differing results on this point, compare, for example, *Grimes v. Donald*, 673 A.2d 1207, 1216 (Del. 1996) (finding that familial interest is a basis for demand excusal), *overruled in part by Brehm v. Eisner*, 746 A.2d 244 (Del. 2000), *Harbor Financial Partners v. Huizenga*, 751 A.2d 879, 889 (Del. Ch. 1999) (CEO’s brother-in-law could not be impartial), and *Mizel v. Connelly*, 1999 Del. Ch. LEXIS 157, at *8 (Del. Ch. Aug. 2, 1999) (grandson could not be impartial), with *Abrams v. Koether*, 766 F. Supp. 237, 256 (D.N.J. 1991) (noting that “allegations that making demand would call on the Defendants to sue their friends, family and business associates are insufficient” to demonstrate demand futility), *Grace Bros. v. UniHolding Corp.*, No. 17612, 2000 Del. Ch. LEXIS 101, at *32 (Del. Ch. July 12, 2000) (finding reasonable doubt whether a director impartially could consider demand adverse to the interests of his brother-in-law) and *Seibert v. Harper & Row, Publishers, Inc.*, No. 6639, 1984 Del. Ch. LEXIS 523, at *9 (Del. Ch. Dec. 5, 1984) (cousin could be impartial).

136 See *Cal. Pub. Employee’s Ret. Sys. v. Coulter*, No. 19191, 2002 Del. Ch. LEXIS 144, at *29 (Del. Ch. Dec. 18, 2002) (“Our cases have determined that personal friendships, without more; *outside business relationships*, without more . . . are each insufficient to raise a reasonable doubt of a director’s ability to exercise independent business judgment.”); *In re The Walt Disney Co. Derivative Litig.*, 731 A.2d 342, 355 (Del. Ch. 1998) (“The fact that the [CEO] has . . . long standing personal and business ties to [the employee] cannot overcome

producing motivations such as prestige or embarrassment.¹³⁷ Thus, a board could be packed with friends and business partners of the CEO without losing its status as independent.

This counterintuitive view ultimately became too much for the courts, and tentative efforts gradually emerged which recognized that non-pecuniary relationships could sometimes impair independence.¹³⁸ As one chancery court acknowledged:

Delaware law should not be based on a reductionist view of human nature that simplifies human motivations on the lines of the least sophisticated notions of the law and economics movement. *Homo sapiens* is not merely *homo economicus*. We may be thankful that an array of other motivations exist that influence human behavior; not all are any better than greed or avarice, think of envy, to name just one. But also think of motives like love, friendship, and collegiality, think of those among us who direct their behavior as best they can on a guiding creed or set of moral values.¹³⁹

Acknowledgement, however, did not translate into practical acceptance. Subsequent decisions remained decidedly unsympathetic to allegations of bias arising out of friendship and outside business activities.¹⁴⁰ With one

the presumption of independence that all directors . . . are afforded.”), *aff’d in part, rev’d in part sub nom.* Brehm v. Eisner, 746 A.2d 244 (Del. 2000); *see also* Orman v. Cullman, 794 A.2d 5, 28 (Del. Ch. 2002).

137 *See* Grobow v. Perot, 539 A.2d 180, 188 (Del. 1988) (“Plaintiffs merely argue that Perot’s public criticism of GM management could cause the directors embarrassment sufficient to lead to their removal from office. Such allegations are tenuous at best and are too speculative to raise a reasonable doubt of director disinterest.”).

138 *See Orman*, 794 A.2d at 27 (“Although mere recitation of the fact of past business or personal relationships will not make the Court automatically question the independence of a challenged director, it may be possible to plead additional facts concerning the length, nature or extent of those previous relationships that would put in issue that director’s ability to objectively consider the challenged transaction.” (citing *In re Ply Gem Indus., Inc. S’holders Litig.*, 15779-NC, 2001 Del. Ch. LEXIS 123 (Del. Ch. Sept. 28, 2001)); *In re New Valley Corp. Derivative Litig.*, No. 17649, 2001 Del. Ch. LEXIS 13, at *25 (Del. Ch. Jan. 11, 2001) (noting in connection with the Court’s consideration of allegations of interest and lack of independence that, “the facts alleged in the complaint show that all the members of the current Board have current or past business, personal, and employment relationships with each other and the entities involved”); *Chesapeake Corp. v. Shore*, 771 A.2d 293, 299 n.4 (Del. Ch. 2000) (“Unitrin defines an independent director as one who can base her judgments on the corporate merits without being influenced by extraneous influences, such as personal relationships the director has with management or a controlling stockholder, or other material financial relationships the director has with the corporation.”).

139 *In re Oracle Corp. Derivative Litig.*, 824 A.2d at 938; *see also Cal. Pub. Employees’ Ret. Sys.*, 2002 Del. Ch. LEXIS 144, at *29 (noting that together, allegations of a personal relationship, outside business relationships and acquiescence in the challenged transactions provided reason to doubt director’s disinterest or independence).

140 *See Crescent/Mach I Partners, L.P. v. Turner*, 846 A.2d 963, 980–981 (Del. Ch. 2003)

unusual exception, no case found this type of relationship to be disqualifying.¹⁴¹

2. *The Non-Development Development.*—The Delaware Supreme Court ultimately intervened in a case involving Martha Stewart, holding for the first time that non-family personal relationships could result in loss of independence. Stewart served as the CEO and chairman of Omnimedia and owned 94% of the stock. The plaintiffs challenged the independence of several directors who served on the board, focusing primarily on Stewart's personal relationships with directors Martinez¹⁴² and Moore.¹⁴³ Despite the fact that Stewart had longstanding friendships with both, the chancery court granted a motion to dismiss, concluding that the allegations in the complaint did not raise reasonable doubt about their independence.¹⁴⁴

(“In support, they allege that Turner controls Hunt because of their long-standing 15-year professional and personal relationship. This allegation alone fails to raise a reasonable doubt that Hunt could not exercise his independent business judgment in approving the transaction.”). More recent cases have suggested a greater degree of openness to the argument. *See Nagy v. Bistricher*, 770 A.2d 43, 49 n.2 (Del. Ch. 2000) (“[A] fiduciary may act disloyally for a variety of reasons other than personal pecuniary interest; and . . . regardless of his motive, a director who consciously disregards his duties to the corporation and its stockholders may suffer a personal judgment for monetary damages for any harm he causes.”); *In re RJR Nabisco, Inc. Shareholders Litig.*, No. 10389, 1989 Del. Ch. LEXIS 9, at *46 (Del. Ch. Feb. 14, 1989) (“Greed is not the only human emotion that can pull one from the path of propriety; so might hatred, lust, envy, revenge, or, as is here alleged, shame or pride. Indeed any human emotion may cause a director to place his own interests, preferences or appetites before the welfare of the corporation.”); *see also Telxon Corp. v. Meyerson*, 802 A.2d 257, 264 (Del. 2002) (“A controlled director is one who is dominated by another party, whether through close personal or familial relationship or through force of will.” (citation omitted)).

141 *See In re Oracle Corp. Derivative Litig.*, 824 A.2d 917. The court only did so in a case involving a special committee where the company had the burden of establishing independence. Interestingly, the Delaware Supreme Court took it upon itself to raise doubts about the validity of the decision. *See Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart*, 845 A.2d 1040, 1054–55 (Del. 2004). In *California Public Employees' Retirement System*, 2002 Del. Ch. LEXIS 144, friendship was one factor among many that caused the court to agree that the plaintiff had sufficiently pled that a director was not independent.

142 *See Beam*, 845 A.2d at 1044. Martinez was recruited for the board by Stewart's long-time personal friend, Charlotte Beers. According to a published article, Patrick stated that Martinez “is an old friend to both me and Martha.” *Id.*

143 The friendship between Moore and Stewart was noted in an article in *Fortune* magazine. *See* Charlotte Beers, Martha Stewart, & Darla Moore, *Cocktails at Charlotte's with Martha and Darla*, FORTUNE, Aug. 5, 1996, at 56.

144 As the Chancery Court noted: “The amended complaint does specify the various retainers, meeting fees, and other perquisites afforded the directors, but it is not obvious from the allegations that such compensation would be sufficient to entice any of the outside directors to ignore fiduciary duties to MSO and its shareholders. Nor does plaintiff suggest that the outside directors have a history of blindly following Stewart's will or even accepting her recommendations without adequate independent study and investigation.” *Beam v. Stewart*, 833 A.2d 961, 978–79 (Del. Ch. 2003).

On appeal, the Delaware Supreme Court took the opportunity to discuss the effect of outside personal relationships on director independence. The court acknowledged that “a variety of motivations” could impair independence, “including friendship.”¹⁴⁵ Nonetheless, friendship alone was not enough.¹⁴⁶ Instead, plaintiffs had to show that “the non-interested director would be more willing to risk his or her reputation than risk the relationship with the interested director.”¹⁴⁷ The opinion discounted relationships that arose from a “structural bias,” whether before or after joining the board.

This test appears to require something akin to a balancing test, weighing friendship against professional reputation. Aside from the absence of guidance on how to do this, the approach suffers from a faulty premise. It presupposes that only friendships strong enough to risk professional reputation can create the possibility of biased decision-making. In fact, friendships of lesser intensity can easily influence directors’ decisions.¹⁴⁸

The test also assumes that decisions to support the CEO over the best interests of shareholders will be harmful to reputation, a zero-sum game of sorts. It is not even entirely clear that every director has a professional reputation that can suffer much harm. Indeed, resolute support for a CEO may actually be seen as an asset.¹⁴⁹ More importantly, not every board deci-

145 *Beam*, 845 A.2d at 1050; see also *In re Compucom Sys., Inc. Stockholders Litig.*, No. 499-N, 2005 Del. Ch. LEXIS 145, at *34 (Del. Ch. Sept. 29, 2005) (“The court recognizes that under certain circumstances, professional, financial, and personal relationships of directors may preclude a finding of independence.” (citing *Krasner v. Moffett*, 826 A.2d 277, 283 (Del. 2003))).

146 The Court adopted the reasoning of the Chancery Court: “Some professional or personal friendships, which may border on or even exceed familial loyalty and closeness, may raise a reasonable doubt whether a director can appropriately consider demand. This is particularly true when the allegations raise serious questions of either civil or criminal liability of such a close friend. Not all friendships, or even most of them, rise to this level and the Court cannot make a *reasonable* inference that a particular friendship does so without specific factual allegations to support such a conclusion.” *Beam*, 845 A.2d at 1050 (citing *Beam*, 833 A.2d at 979).

147 *Id.* at 1052. Although focusing on friendship, subsequent courts have held that the analysis also applied to outside business relationships. See *Khanna v. McMinn*, No. 20545-NC, 2006 Del. Ch. LEXIS 86, at *60 (Del. Ch. May 9, 2006) (noting that while *Beam* primarily applied to social relationships, the analysis also applied to business relationships).

148 This approach seems to presume that the director must either support the CEO or shareholders. Most decisions are, however, more complicated than that. Friendship may simply tip the balance at the margin.

149 Directors who have a reputation for objecting to actions by the CEO may find it difficult to find a board that will accept them. See Troy A. Paredes, *Corporate Decisionmaking: Too Much Pay, Too Much Deference: Behavioral Corporate Finance, CEOs, and Corporate Governance*, 32 FLA. ST. U. L. REV. 673, 730 (2005) (“[O]utside directors face only a slight risk of legal liability under state corporate law for failing to satisfy their responsibility to act with due care, even when they are relatively passive and essentially go along with management’s recommendations for the business. Accordingly, there is little upside if directors oppose or even seriously challenge the CEO, and yet there are downside risks for doing so.” (footnote omitted)).

sion involves a stark Hobson's choice between shareholders and interested directors. Given the broad and malleable nature of fiduciary duties, it will rarely be clear that a decision was designed to favor the interested director at the expense of shareholders.

Subsequent decisions have provided little clarity but have continued the pre-*Beam* tradition of refusing to find any personal relationship sufficient to impair independence. Thus, in *Khanna v. McMinn*, the plaintiff alleged that two directors had a close personal relationship that included the ownership of homes in the same neighborhood and in "neighboring wineries."¹⁵⁰ The court conceded that the directors were "not strangers—indeed, they may be fairly close."¹⁵¹ Nonetheless, the facts were considered little more than a "characterization that they are close friends," resulting in dismissal without discovery.¹⁵²

Beam corrected an obvious and embarrassing analytical weakness in Delaware's approach to independence.¹⁵³ The strong suggestion that non-familial, non-pecuniary relationships could not impair independence was inconsistent with common sense and provided the appearance of an outcome-determinative test. At the same time, however, *Beam* and its progeny have continued to impose an essentially insurmountable barrier in the analysis of these relationships,¹⁵⁴ with such cases routinely dismissed.¹⁵⁵ Indeed, the court in *Beam* went out of its way to emphasize that friendships arising as a result of board membership would not be subject to challenge. The court did so even though the issue was irrelevant to the case and even though independence focuses on the nature of the relationship rather than the method of formation.¹⁵⁶ Thus, notwithstanding the ostensible ground-

150 *Khanna*, 2006 Del. Ch. LEXIS 86 at *10.

151 *Id.* at *19.

152 *Id.* at *77.

153 The motivation may have been to fend off federal intervention. *See infra* note 235.

154 *See Benihana, Inc. of Tokyo v. Benihana, Inc.*, 891 A.2d 150, 179 (Del. Ch. 2005) (finding that director did not lose independence despite forty to forty-five year friendship and meeting with interested director every ten to fourteen days; evidence of a "longstanding friendship" not enough to show loss of independence), *aff'd*, 906 A.2d 114 (Del. 2006); *see also Velasco, supra* note 14, at 844 (describing burden on plaintiffs of proving a disqualifying friendship as "especially onerous given that the plaintiff is required to make its case on the pleadings, with particularized allegations, and without the benefit of discovery.").

155 *See Gatz v. Ponsoldt*, No. 174-N, 2004 Del. Ch. LEXIS 203, at *21 (Del. Ch. Nov. 8, 2004) ("Although the complaint alleges that one of the members of the independent committee, Glasser, has had 'significant prior business dealings with Levy,' such a conclusory allegation does not demonstrate that Glasser has an inability to consider impartially issues related to potential transgressions involving Levy, let alone Ponsoldt." (footnote omitted)).

156 The entire analysis was dicta given that the relationships with Stewart preceded their time together on the board. *See Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart*, 845 A.2d 1040, 1051 (Del. 2004) ("Even if the alleged friendships may have preceded the directors' membership on MSO's board and did not necessarily arise out of that membership, these relationships are of the same nature as those giving rise to the structural

breaking nature of the analysis in *Beam*,¹⁵⁷ little has changed in practice.¹⁵⁸ Personal relationships are not a meaningful basis for challenging board independence.¹⁵⁹

IV. THE PRESUMPTION OF INDEPENDENCE AND UNREASONABLE PLEADING STANDARDS

The courts use a variety of analytically inconsistent mechanisms to dismiss challenges to a director's independence. They purport to rely on a materiality threshold but ignore it when convenient, as in the application (or non-application) to directors' fees. The courts acknowledge that personal and outside business relationships can impair independence, but apply a test that all but guarantees that these relationships never do. Mostly, though, the courts use unreasonable pleading standards to dismiss challenges before discovery has occurred.¹⁶⁰

bias argument.”).

157 Some commentators saw a hopeful shift in the law when the Chancery Court held in *Oracle* that personal relationships could result in a loss of independence. See Paredes, *supra* note 149, at 731 (describing the case as a noteworthy trend). The opinion in *Beam*, particularly its unusual decision to discuss and criticize *Oracle*, has made the trend a short one. See *Beam*, 845 A.2d at 1054–55 (criticizing the *Oracle* decision).

158 See Lisa M. Fairfax, *Sarbanes-Oxley, Corporate Federalism, and the Declining Significance of Federal Reforms on State Director Independence Standards*, 31 OHIO N.U. L. REV. 381, 402 (2005) (“As a practical matter, the approach demonstrates a judicial desire to impede these types of challenges. The basis, however, has little to do with a desire to determine independence. Instead, courts seem more concerned with the widespread nature of board friendships and the possibility of constant challenges. To the extent these relationships can be a basis for challenging a director's independence, the status of all independent directors will arguably be open to challenge.”).

159 For a discussion of relationships that can arise through interaction on the board and their impact on decision making, see Marleen A. O'Connor, *The Enron Board: The Perils of Groupthink*, 71 U. CIN. L. REV. 1233, 1246 (2003) (“On the upside, long terms for directors foster collegiality that promotes the notion of ‘fictive friendship’ among directors. To a certain degree, cohesiveness is essential to promote good working relationships among board members. On the downside, the presence of such ‘fictive friendships’ on the board creates social norms that make it inappropriate for the independent directors to challenge their ‘friends.’”).

160 See *Beam*, 845 A.2d at 1056 (“In general, derivative plaintiffs are not entitled to discovery in order to demonstrate demand futility.” (footnote omitted)); *Rales v. Blasband*, 634 A.2d 927, 934 n.10 (Del. 1993) (“[Derivative plaintiffs] are not entitled to discovery to assist their compliance with Rule 23.1” (citation omitted)); *Levine v. Smith*, 591 A.2d 194, 208–210 (Del. 1991) (refusing to extend the availability of limited discovery to either demand refused cases or demand excused cases, absent the *Zapata* context relating to an SLC), *overruled in part by Brehm v. Eisner*, 746 A.2d 244 (Del. 2000); see also *Scattered Corp. v. Chi. Stock Exch.*, 701 A.2d 70, 77 (Del. 1997) (“The law in Delaware is settled that plaintiffs in a derivative suit are not entitled to discovery to assist their compliance with the particularized pleading requirement of Rule 23.1 in a case of demand refusal. A plaintiff's standing to sue in a derivative suit, whether based on demand-refused or demand-excused, must be determined on the basis of the well-pleaded allegations of the complaint.” (footnotes omitted)), *overruled*

The courts routinely require as part of the particularity standard facts that are not readily available.¹⁶¹ They often blame shareholders for the absence of the required information, insisting that it resulted from a failure to invoke inspection rights.¹⁶² In fact, the necessary information is rarely, if ever, available this way, something clear at least to some Delaware courts. The required use of inspection rights, therefore, does little more than delay and increase costs with little resulting advantage.¹⁶³

The courts also apply the higher pleading standards in an inconsistent fashion. Sometimes plaintiffs are allowed a reasonable inference from the alleged facts,¹⁶⁴ but more often they are not. Other times the courts seem to change the rules mid-stream, finding that plaintiffs alleged the wrong facts.¹⁶⁵ After making their own factual findings, courts sometimes dispose of the cases on a motion to dismiss.¹⁶⁶

in part by Brehm, 746 A.2d 244; *Kaufman v. Belmont*, 479 A.2d 282, 289 (Del. Ch. 1984) (“In the Rule 23.1 context only the pleadings are considered and the plaintiff is not entitled to take discovery to supplement his allegations of demand futility.” (citations omitted)).

161 See *supra* note 121.

162 See *infra* note 187.

163 Shareholders may only recover attorney fees associated with an action under section 220 if they can establish bad faith, a difficult standard. See *Haywood v. AmBase Corp.*, 2005 Del. Ch. LEXIS 131 (Del. Ch. Aug. 22, 2005).

164 See *Zimmerman v. Braddock*, No. 18473-NC, 2005 Del. Ch. LEXIS 135, at *43 n.95 (Del. Ch. Sept. 8, 2005) (deeming allegations that company was one of two largest clients sufficient despite absence of any facts concerning the amount of business or its importance; “given that the Plaintiff is entitled to all fair and reasonable inferences from the well-pled facts alleged in its Second Amended Complaint, at this stage of the proceedings it would be unreasonable not to infer the materiality of Priceline’s business to Worldspan”), *rev’d*, 906 A.2d 776 (Del. 2006).

165 Thus, in *In re J.P. Morgan Chase & Co. S’holder Litig.*, 906 A.2d 808 (Del. Ch. 2005), one of the directors served as the president and CEO of a non-profit. Plaintiff alleged that the organization received \$1 million in matching donations from JPMC in 2003 and that JPMC and its employees contributed over \$18 million since 1990. Finally, the CEO of JPMC served as treasurer. *Id.* at 815. Despite the considerable amount of information about the relationship, the court concluded that the facts did not meet the “particularity” requirement. Essentially, shareholders relied on the wrong facts; it was not the dollar amount of the relationship that was important. “[T]he plaintiffs fail to indicate how JPMC’s contributions would affect UNCF and therefore influence Gray. The plaintiffs provide only the dollar value, not the representative percentage, of JPMC’s contributions to UNCF.” *Id.* at 824.

166 In *Khanna v. McMinn*, No. 20545-NC, 2006 Del. Ch. LEXIS 86 (Del. Ch. May 9, 2006), the plaintiffs argued that a director who was president and CEO of one of the defendant company’s customers was not independent because he “would not want to jeopardize the current pricing structure offered [to his company.]” *Id.* at *87. The court concluded, at the pleading stage, that a customer would not fear a price increase from the company because the services could be purchased elsewhere. The court ruled that “the Plaintiffs’ allegations are insufficiently particularized to displace the notion that, in this context, if Covad unilaterally raised its prices relative to the market, TelePacific would purchase from another, lower-priced seller.” *Id.* at *88. Given that the case was at the pleading stage and the court had no information about the elasticity of the particular market, the conclusion was a factual determination made without the benefit of facts.

Finally, courts simply ignore facts that indicate a disqualifying relationship.¹⁶⁷ They commonly decide the issue of independence as if plaintiffs had to meet their substantive burden in the complaint, rather than merely providing a “reasonable basis.” As a result, they dismiss the claims without allowing further exploration into the nature of the relationship.

A. Heightened Standards

Delaware courts presume independence.¹⁶⁸ To overcome the presumption, plaintiffs must allege facts that demonstrate “reasonable doubt” about a director’s independence.¹⁶⁹ Furthermore, the facts must be pled with particularity,¹⁷⁰ a standard substantially greater than the one applied to notice pleading.¹⁷¹

This heightened pleading requirement emanates from rule 23.1, the provision addressing derivative suits.¹⁷² The rule requires that demand

¹⁶⁷ Here the cases are too numerous to list. *Disney* is a good example. See *infra* notes 199–249 and accompanying text. So is *Beam*. See *infra* notes 184–85 and accompanying text.

¹⁶⁸ *Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart*, 845 A.2d 1040, 1049 (Del. 2004).

¹⁶⁹ *Aronson v. Lewis*, 473 A.2d 805, 815 (Del. 1984), *overruled in part by Brehm v. Eisner*, 746 A.2d 244 (Del. 2000).

¹⁷⁰ The burden rests with the plaintiff, subject to two exceptions. The first is where a board, in a demand futility case, seeks to form a special committee to consider whether to maintain the action. In those circumstances, the board bears the burden of establishing the independence of the members. *In re Oracle Corp. Derivative Litig.*, 824 A.2d 917, 937 (Del. Ch. 2003) (“I begin with an important reminder: the SLC [special litigation committee] bears the burden of proving its independence.”); see also *Beam*, 845 A.2d at 1055 (“Unlike the demand-excusals context, where the board is presumed to be independent, the SLC has the burden of establishing its own independence by a yardstick that must be ‘like Caesar’s wife’—‘above reproach.’” (footnote omitted)). The other involves transactions between the company and controlling shareholders. In those circumstances, the board may form a special committee, but it has the burden of establishing that the directors are independent. *Kahn v. Tremont Corp.*, 694 A.2d 422, 429 (Del. 1997); see also *Emerald Partners v. Berlin*, 726 A.2d 1215, 1222–23 (Del. 1999) (“This Court has identified two scenarios that can provide the basis for shifting the burden to the *plaintiff* to demonstrate that the transaction complained of was *not* entirely fair. First, an approval of the transaction by an independent committee of directors who have real bargaining power that can be exerted in dealings with a majority shareholder who does not dictate the terms of the merger may supply the necessary basis for shifting the burden.” (citations omitted)); *In re Tele-Comm’n, Inc. S’holders Litig.*, No. 16470, 2005 Del. Ch. LEXIS 206, at *33 (Del. Ch. Dec. 21, 2005) (“In order to shift the burden, defendants must establish that the special committee was truly independent, fully informed, and had the freedom to negotiate at arm’s length.” (footnote omitted)).

¹⁷¹ See *White v. Panic*, 783 A.2d 543, 553 n.34 (Del. 2001) (quoting *Brehm v. Eisner*, 746 A.2d 244, 553 n.34 (Del. 2000)); see also *Brehm*, 746 A.2d at 254 (“[Rule 23.1] pleadings must comply with stringent requirements of factual particularity that differ substantially from the permissive notice pleadings.”).

¹⁷² See *Benihana of Tokyo, Inc. v. Benihana, Inc.*, 891 A.2d 150, 176 n.154 (Del. Ch. 2005) (noting that cases dealing with director independence under section 144 and rule 23.1 applied

futility be pled “with particularity.”¹⁷³ The higher standard prevents the shareholder from causing “the corporation to expend money and resources in discovery and trial in the stockholder’s quixotic pursuit of a purported corporate claim based solely on conclusions, opinions or speculation.”¹⁷⁴ The heightened standard also applies regardless of whether the issue arises in the context of demand excuse or the duty of loyalty.¹⁷⁵

B. Impact of the Heightened Standards

The problem is not simply that the courts impose higher standards. The standards are applied in a manner that is essentially impossible to meet, something courts have occasionally acknowledged.¹⁷⁶ In the absence of discovery, plaintiffs are left with whatever information can be gleaned from public sources.¹⁷⁷ While some information bearing on independence must appear in the periodic reports and proxy statements of public companies,¹⁷⁸ the sources rarely provide information adequate to meet the specificity requirements. Moreover, such reports do not always disclose information about these relationships, even when legally required to do so.¹⁷⁹

same standard), *aff’d*, 906 A.2d 114 (Del. 2006)..

173 Plaintiffs must allege in the complaint “with particularity the efforts, if any, . . . made by the plaintiff to obtain the action the plaintiff desires from the directors or comparable authority and the reasons for the plaintiff’s failure to obtain the action or for not making the effort.” White, 783 A.2d at 551 n.20 (quoting DEL. CH. CT. R. 23.1).

174 Brehm, 746 A.2d at 254–55.

175 See Orman v. Cullman, 794 A.2d 5, 25 (Del. Ch. 2002).

176 See *supra* note 121.

177 See Rales v. Blasband, 634 A.2d 927, 934 n.10 (Del. 1993) (“[D]erivative plaintiffs . . . are not entitled to discovery to assist their compliance with Rule 23.1 . . .” (citation omitted)).

178 See Item 401 of Regulation S-K, 17 C.F.R. § 229.401(g)(2)(h)(1)(B) (2006) (specifying information that must be disclosed about directors, including business experience, other directorships, family relationships, and involvement in certain legal proceedings); Item 404 of Regulation S-K, 17 C.F.R. § 229.404 (2006) (addressing disclosure of certain relationships and related-party transactions by directors).

179 Disney, for example, failed to disclose that three directors—Reveta Bowers, Stanley Gold, and Ray Watson—had children working for the company, receiving salaries from \$60,000 to more than \$150,000. See *In re* Disney, Exchange Act Release No. 50882 2004 SEC LEXIS 3000, at 3–4 (Dec. 20, 2004). In addition, Disney paid a company owned by Roy Disney for services, with the payments amounting to more than five percent of the company’s gross revenues, and those were not the only omissions. *Id.* at *5 (noting that the wife of one director was employed by company where Disney held a fifty percent interest and received a salary of more than \$1 million; another director received undisclosed compensation of secretarial services and a leased car with a driver). The case did not reveal whether the relationship existed at the time of the decision assessing the independence of the Disney directors. See *In re* The Walt Disney Co. Derivative Litig., 731 A.2d 342 (Del. Ch. 1998), *aff’d in part, rev’d in part sub nom.* Brehm v. Eisner, 746 A.2d 244 (Del. 2000). For a similar situation involving a different company, see Millenco LP v. meVC Draper Fisher Jurvetson Fund I, Inc., 824 A.2d 11, 15–17

The difficulty is particularly acute given the use of a subjective materiality standard. At the pleading stage, plaintiffs may need to produce facts concerning the amount of an income stream and its importance,¹⁸⁰ the specific financial condition of each individual director,¹⁸¹ the compensation formula used by the firm receiving the funds,¹⁸² and the CEO's specific authority concerning the renewal of a lease.¹⁸³ None of this information is typically available from public sources.

The same is true of disqualifying personal relationships. Courts have imposed a test that requires, at the pleading stage, a considerable amount of evidence about the strength of the friendship. This type of information is ordinarily difficult to discern from public sources given its personal and private nature. Yet where plaintiffs have managed to uncover public information about these relationships, the courts have nonetheless dismissed the plaintiffs' complaints for lack of specificity.

Take *Beam*. The plaintiffs found an interview in *Fortune* magazine of three people: Martha Stewart; Darla Moore, the allegedly non-independent director; and Charlotte Beers, another longstanding friend, who Moore replaced on the board. The three women described themselves as "best buddies" and the interview unquestionably had a relaxed and friendly tone.¹⁸⁴ In addition, plaintiffs produced evidence that Moore and Stewart attended

(Del. Ch. 2002) (finding that proxy statement failed to disclose business relationships between inside and two "independent" directors in violation of state fiduciary obligations of disclosure). In other cases, disclosure of information suggesting a disqualifying relationship may not always be required. See Alan Murray, *How UnitedHealth Spotlights Gap in Reform*, WALL ST. J., Oct. 18, 2006, at A2 (noting that company did not disclose that director who chaired compensation committee "served as trustee for two trusts benefiting the CEO's children and managed between \$15 million and \$55 million of the [CEO's] family fortune" and that CEO invested \$500,000 in director's business).

180 See *In re Compucom Sys., Inc.*, No. 499-N, 2005 Del. Ch. LEXIS 145, at *21 (Del. Ch. Sept. 29, 2005) (finding consulting relationship insufficient where plaintiff did not allege facts establishing materiality of relationship); see also *Khanna v. McMinn*, No. 20545-NC, 2006 Del. Ch. LEXIS 86, at *64–65 (Del. Ch. May 9, 2006) (noting that plaintiff alleged that customer bought \$2.2 million from company, but holding that the court could not discern materiality of amount from facts in complaint).

181 See *In re The Walt Disney Co. Derivative Litig.*, 731 A.2d at 360.

182 See *id.* for a discussion of Mitchell's employment by a law firm used by Disney. The court notes that the plaintiffs "have not indicated that Mitchell, as 'special counsel' (and not 'partner') shared in the legal fees paid to his firm." *Id.*

183 See *Litt v. Wycoff*, No. 19083-NC, 2003 Del. Ch. LEXIS 23, at *19 n.34 (Del. Ch. Mar. 28, 2003) ("The Complaint does not support any contention that Wycoff, as Chief Executive Officer, is vested with unilateral non-reviewable authority to breach contracts on behalf of Progress, was the unilateral decision-maker for leasing the property in question, or could be expected to be the unilateral decision-maker with respect to renewal of the fifteen-year lease upon its expiration.").

184 See Charlotte Beers, Martha Stewart & Darla Moore, *Cocktails at Charlotte's with Martha and Darla*, *FORTUNE*, Aug. 5, 1996, at 56.

a social function that almost certainly had a restricted invitation list.¹⁸⁵ Finally, Stewart owned ninety-four percent of the voting stock, giving her final say on any possible board candidate.

Plaintiffs only needed to present a “reasonable doubt” about independence. Without anything that would pass for analysis, the court concluded that “these bare social relationships clearly do not create a reasonable doubt of independence.”¹⁸⁶ This was a mischaracterization. Plaintiffs did more than allege “bare social relationships.” The complaint specifically asserted that Stewart and Moore had a longstanding friendship and provided support for this contention. The court also failed to indicate information that would suffice and did not recognize the practical difficulties in obtaining public information about friendships.

C. The Search for Particularized Facts

In what has to be an odd twist, the Delaware courts ultimately recognized the difficulties imposed on plaintiffs in pleading “with specificity” facts that are not publicly available. Rather than do the obvious and either loosen the pleading requirements or permit limited discovery, they forced shareholders to invoke their inspections rights and examine the books and records of the company. Shareholders were chastised for failing to use these “tools at hand” before bringing an action to challenge director independence.¹⁸⁷

The notion that inspection rights might substitute for discovery is, in most cases, far-fetched. The likelihood that this avenue would uncover information useful in determining subjective materiality or the strength of a

185 It was a wedding reception held by Stewart’s lawyer for his daughter. *See* *Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart*, 845 A.2d 1040, 1046 (Del. 2004); *see also* David Marcus, *Norm’s Swan Song*, DAILY DEAL, Apr. 12, 2004, 2004 WLNR 17772320.

186 *See* *Beam*, 845 A.2d at 1054.

187 *See id.* at 1056 (“Beam’s failure to plead sufficient facts to support her claim of demand futility may be due in part to her failure to exhaust all reasonably available means of gathering facts. As the Chancellor noted, had Beam first brought a Section 220 action seeking inspection of MSO’s books and records, she might have uncovered facts that would have created a reasonable doubt.” (footnotes omitted)); *Rales v. Blasband*, 634 A.2d 927, 935 n.10 (Del. 1993) (“[T]hey have many avenues available to obtain information bearing on the subject of their claims. For example, there is a variety of public sources from which the details of a corporate act may be discovered, including the media and governmental agencies such as the Securities and Exchange Commission. In addition, a stockholder who has met the procedural requirements and has shown a specific proper purpose may use the summary procedure embodied in 8 Del. C. § 220 to investigate the possibility of corporate wrongdoing.” (citation omitted)); *In re J.P. Morgan Chase & Co. S’holder Litig.*, 906 A.2d 808, 823 (Del. Ch. 2005) (“Finally, as noted above, the plaintiffs here did not make a section 220 books and records demand. If they had, they would have been able to investigate the decision-making process behind the qualification of the directors as independent under the NYSE Corporate Governance rules. Instead, they rely on conclusory allegations that do not create a reasonable doubt about Futter’s or Kaplan’s independence based on the charitable ties to The American Museum of Natural History.”).

personal friendship is negligible. The types of records that demonstrate a lack of independence will rarely be in the possession of the corporation.¹⁸⁸ Yet this is the very position taken by the courts. In *Beam*, the Delaware Supreme Court delineated some of the types of information that might be available:

For example, irregularities or “cronism” in [the company’s] process of nominating board members might possibly strengthen her claim concerning Stewart’s control over [the company’s] directors. A books and records inspection might have revealed whether the board used a nominating committee to select directors and maintained a separation between the director-selection process and management. A books and records inspection might also have revealed whether Stewart unduly controlled the nominating process or whether the process incorporated procedural safeguards to ensure directors’ independence. *Beam* might also have reviewed the minutes of the board’s meetings to determine how the directors handled Stewart’s proposals or conduct in various contexts.¹⁸⁹

The information, which the court conceded “might possibly” strengthen a claim, relates more to the issue of control over the nomination process—not to the strength of the friendship.¹⁹⁰ Stewart, with ninety-four percent of the voting shares, already had complete control.¹⁹¹ How additional evidence of

188 That fact, however, does not prevent the courts from claiming otherwise. *See In re J.P. Morgan Chase & Co. S’holder Litig.*, 906 A.2d 808, 820 (Del. Ch. 2005) (“Furthermore, the plaintiffs could have used section 220 to learn more about the relationships between Harrison [the CEO] and the defendant directors. As the Delaware Supreme Court noted in *Beam*, plaintiffs who seek information under section 220 may be able to review the minutes of board meetings and determine how the directors handled the CEO’s proposals or conduct in various contexts. Armed with this information, the plaintiffs may have been able to link the alleged relationships to directors’ conduct through particularized facts.” (footnote omitted)). At most, the information would show how directors voted, information generally viewed by Delaware courts as irrelevant in determining independence. *See Khanna*, 2006 Del. Ch. LEXIS 86, at *57–58.

189 *Beam*, 845 A.2d at 1056 (footnote omitted); *see also Amalgamated Bank v. UICI*, No. 884-N, 2005 Del. Ch. LEXIS 82 (Del. Ch. June 2, 2005) (quoting favorably the language employed by the Supreme Court of Delaware in *Beam*, 845 A.2d at 1056); *Haywood v. AmBase Corp.*, No. 342-N, 2005 Del. Ch. LEXIS 131, at *28 (Del. Ch. Aug. 22, 2005) (same); *Beam v. Stewart*, 833 A.2d 961, 981–82 (Del. Ch. 2003) (“It is troubling to this Court that, notwithstanding repeated suggestions, encouragement, and downright admonitions over the years both by this Court and by the Delaware Supreme Court, litigants continue to bring derivative complaints pleading demand futility on the basis of precious little investigation beyond perusal of the morning newspapers.”).

190 This assumes that companies preserve evidence of “cronism” in their minutes, an unlikely proposition.

191 *See Beam*, 845 A.2d at 1045 (“Martinez was recruited for the board by Stewart’s longtime personal friend, Charlotte Beers When Beers, a longtime friend and confidante to Stewart, resigned from the Company’s board in September 2001, Moore was nominated to

“cronyism” would affect the analysis is hard to discern,¹⁹² particularly given the court’s general impatience with this type of information.¹⁹³

Using inspections rights as a substitute for discovery has other problems. Minutes of board meetings are often thin in content,¹⁹⁴ and therefore will not typically reveal problems among directors or cronyism. Nor is the provision allowing inspection easy to use. Shareholders must have a proper

replace her.”).

192 See *In re W. Nat’l Corp. S’holders Litig.*, No. 15927, 2000 Del. Ch. LEXIS 82, at *52–53 (Del. Ch. May 22, 2000) (“Directors must be nominated and elected to the board in one fashion or another. The fact that a company’s executive chairman or a large shareholder played some role in the nomination process should not, without additional evidence, automatically foreclose a director’s potential independence.” (footnote omitted)); see also *Aronson v. Lewis*, 473 A.2d 805, 815 (Del. 1984) (observing that a forty-seven percent stockholder who personally selected all of the directors of the corporation was not sufficient to establish that the stockholder dominated and controlled the corporation’s board of directors), *overruled in part by Brehm v. Eisner*, 746 A.2d 244 (Del. 2000); *In re W. Nat’l Corp. S’holders Litig.*, 2000 Del. Ch. LEXIS 82, at *53 (“Essentially, plaintiffs ask that I declare these two outside directors incapable of exercising independent, good faith business judgment merely because they did not find their way onto the Company’s board through an independent nominating committee. Although independent nominating committees may indeed have a salutary effect on board efficacy and independence, and are surely a ‘best practice’ which the corporate governance community endorses, they are not a sine qua non for director independence under Delaware law.” (footnote omitted)); *Andraea v. Andraea*, No. 11905, 1992 Del. Ch. LEXIS 44, at *13 (Del. Ch. Mar. 5, 1992) (noting that Delaware courts have consistently rejected the notion that a director cannot act independently of the entity that appointed him or her to the board).

193 See *Weinstein Enters. v. Orloff*, 870 A.2d 499, 512 (Del. 2005) (“To establish that the committee was not independent, it is not enough for Orloff to assert that the Mays directors were nominated by Weinstein, the majority stockholder that controlled the outcome of the board election.” (footnote omitted)); *Benihana of Tokyo, Inc. v. Benihana, Inc.*, 891 A.2d 150, 177 (Del. Ch. 2005) (“Becker’s appointment to the Bluegreen board did not involve extraordinary circumstances; people normally get appointed to boards through personal contacts.”), *aff’d*, 906 A.2d 114 (Del. 2006); *Official Comm. of Unsecured Creditors of Integrated Health Servs., Inc. v. Elkins*, No. 20228-NC, 2004 Del. Ch. LEXIS 122, at *38 (Del. Ch. Aug. 24, 2004) (“Since the Complaint pleads a pattern of Board deferral to Elkins, the Plaintiff argues, the Board can be said to lack independence from Elkins. General allegations of domination over a Board are simply not sufficient under Delaware law to state a traditional duty of loyalty claim.” (footnote omitted)); *In re The Ltd., Inc. S’holders Litig.*, No. 17148-NC, 2002 Del. Ch. LEXIS 28, at *24 (Del. Ch. Mar. 27, 2002) (“Gee, as the result of nominations by Mr. Wexner, serves on the boards of both The Limited and a subsidiary of The Limited. These facts, whether viewed singly or cumulatively, do not support any inference questioning Gee’s independence.”).

194 Donald Pease, *Outside Directors: Their Importance to the Corporation and Protection from Liability*, 12 DEL. J. CORP. L. 25, 62 (1987) (“It is essential, therefore, that the minutes specify the action taken and other matters considered at any meeting. Since minutes are subject to subpoena, they should be carefully written to reflect accurately the action taken and the other items on the agenda that were considered. Minutes should not include extraneous and unnecessary information.”). Needless to say, to the extent information about the nomination process may somehow contribute to a finding of lack of independence, the information may be deemed “extraneous and unnecessary.”

purpose,¹⁹⁵ describe the sought after records with particularity, and pay the expenses associated with any challenge,¹⁹⁶ resulting in delay and additional costs with little benefit.¹⁹⁷

The emphasis on inspection rights has obscured the real problem. The failure to meet the pleading requirements does not flow from a systematic failure of shareholders to seek the necessary facts. The real problem arises from a pleading standard that imposes unrealistic burdens and is applied inconsistently. The solution is not to require an invocation of inspection rights but to permit discovery on the issue.¹⁹⁸

V. CASE STUDY: THE SAGA OF THE TWO MICHAELS

Perhaps the best single case to illustrate the problems discussed in this article is the derivative suit filed against the Disney board in connection with the employment contract awarded to Michael Ovitz. The contract was, by most measures, excessive, paying Ovitz a reported \$140 million for slightly more than a year of unsuccessful service.¹⁹⁹

An employment contract for an executive who is not a member of the board would ordinarily be subject to the business judgment rule and presumed fair. To the extent that an agreement benefits someone on the board, however, the duty of loyalty applies, leaving the directors the burden of establishing fairness. To render this standard applicable, therefore, shareholders in *Disney* had to establish that Michael Eisner somehow benefited from the Ovitz employment contract. They asserted both that Eisner influenced the terms of the agreement out of his friendship with Ovitz and that he controlled the board.²⁰⁰

195 *Haywood v. Ambase Corp.*, 2005 Del. Ch. LEXIS 131, at *22 (Del. Ch. Aug. 22, 2005) (“Haywood and Cronin seek to inspect AmBase’s books and records to determine exactly these types of things. In the circumstances of this case, the evidence provides a reasonable basis to question the board’s independence. Thus, I find that Haywood and Cronin’s desire to investigate that subject constitutes a proper purpose for a § 220 demand.”).

196 Where companies wrongfully refuse to permit inspection, requiring litigation, courts do not routinely award costs to shareholders. *See supra* note 163.

197 For example, the courts have made it very difficult for shareholders to obtain copies of records held by a subsidiary, at least where the subsidiary had independent directors on the board. *See Weinstein Enters.*, 870 A.2d at 511.

198 *See infra* note 236. At least one court has acknowledged the practical difficulty of obtaining the information necessary to meet the pleading requirements. *See supra* note 121.

199 *Brehm v. Eisner*, 746 A.2d 244, 253 (Del. 2000) (describing the payment as over \$140 million, including \$39 million in cash). The amount and terms seemed excessive, providing arguably inappropriate incentives. Under the agreement, Ovitz gained greater amounts the sooner he quit. Ordinarily, compensation is designed to retain management rather than encourage management to quit.

200 According to the complaint:

Eisner is a long-time colleague of Ovitz who, at least at the time

On a motion to dismiss, without the benefit of discovery, the chancery court concluded the plaintiffs had not produced “reasonable doubt” about the independence of the Disney board. In reaching that conclusion, the court found as “independent”: a director who served as an officer,²⁰¹ a director who headed a charity that received \$1 million directly from Eisner,²⁰² a director who was a principal of an elementary school at one time attended by Eisner’s children,²⁰³ a director who received \$50,000 for consulting services and who worked for a law firm representing Disney,²⁰⁴ and a director whose wife received funds to start her business.²⁰⁵ This so called “independ-

of the Employment Agreement was “negotiated,” was a close personal friend of Ovitz. In fact, as Ovitz stated in conjunction with the announcement of his departure from the Company, “Michael Eisner has been my good friend for 25 years and that will not change”

Stockholders’ Derivative Complaint at 21-22, *Brehm v. Eisner*, No. 15452 NC (Del. Ch. Jan. 6, 1997).

201 Roy Disney served as a “top executive” and received “numerous, valuable options on Disney stock.” *In re The Walt Disney Co. Derivative Litig.*, 731 A.2d 342, 356 (Del. Ch. 1998), *aff’d in part, rev’d in part sub nom. Brehm*, 746 A.2d 244. The court, however, gleaned facts from the proxy statement (despite the fact that the matter was being heard on a motion to dismiss) that Disney and his family owned approximately 8.4 million shares with a value of \$2.1 billion. *Id.* The court concluded that the “only reasonable inference that I can draw about Mr. Disney is that he is an economically rational individual whose priority is to protect the value of his Disney shares, not someone who would intentionally risk his own and his family’s interests in order to placate Eisner.” *Id.* The court did so while lumping all shares of the Disney “family” together, without isolating the benefit to Roy Disney or defining what was meant by “family.” More importantly, while it is possible that share ownership may compensate for the income stream received by Roy Disney, this seems to be an intensely factual issue. For example, *Disney* was about the amount paid to Ovitz. The impact of the payment on share prices presumably would need to be greater than the income stream (salary) received by Roy Disney. Nothing in the case addresses the issue.

202 *In re The Walt Disney Co. Derivative Litig.*, 907 A.2d 693, 761 n.488 (Del. Ch. 2005), *aff’d sub nom. Brehm v. Eisner*, 906 A.2d 27 (Del. 2006) (“O’Donovan was president of Georgetown University from 1989 to 2001, (Eisner served on Georgetown University’s board of directors from 1985 to 1991) where Eisner’s son attended college until 1992, and to which Eisner made a \$1 million donation in 1996 at O’Donovan’s request.” (citations omitted)).

203 *See id.* (“Reveta Bowers is an administrator of a private school in West Hollywood, California, that was attended by three of Eisner’s children, and to which Eisner and entities related to the Company have made substantial contributions” (citations omitted)). To arrive at the conclusion, the court had to determine categorically that directors’ fees were not material. For a criticism of that conclusion, see Larry Catá Backer, *People of Color, Women, and the Public Corporation: Director Independence and the Duty of Loyalty: Race, Gender, Class, and the Disney-Ovitz Litigation*, 79 ST. JOHN’S L. REV. 1011, 1061 (2005).

204 *See In re The Walt Disney Co. Derivative Litig.*, 907 A.2d at 761 n.488 (“Mitchell was hand-selected by Eisner to serve on the board, and now serves as chairman, a position which provides Mitchell with substantial remuneration worth about \$500,000 annually” (citations omitted)). Mitchell also worked for a law firm that billed Disney more than \$120,000.

205 *In re The Walt Disney Co. Derivative Litig.*, 731 A.2d at 358 (“The \$121,122 payment to Wilson’s wife’s design firm for services performed is immaterial to Wilson, a man who received a bonus and stock options that, by Plaintiffs’ own estimations, have resulted in over \$70 mil-

dent” board was branded the worst corporate board for two years running by a magazine surveying corporate governance practices.²⁰⁶

But it was the analysis of the relationship between the two Michaels that stretched reality the furthest. Plaintiffs argued the long term “personal” and “business” relationship between the two men rendered Eisner interested in the Ovitz employment contract. Eisner, the plaintiffs argued, was motivated by friendship rather than the best interests of shareholders in negotiating with Ovitz.

The trial court treated the entire approach in a dismissive fashion, disposing of the matter in two sentences:²⁰⁷ “This argument, however, finds no support under Delaware law. The fact that Eisner has long-standing personal and business ties to Ovitz cannot overcome the presumption of independence that all directors, including Eisner, are afforded.”²⁰⁸ That was it. No analysis. No facts. No discovery.²⁰⁹

On appeal, the Supreme Court relied on the same superficial and cursory reasoning.²¹⁰ The decision said nothing about the close relationship between the two men and again, in two sentences, dismissed the claim.

The Court of Chancery held that “no reasonable doubt can exist as to Eisner’s disinterest in the approval of the Employment Agreement, as a matter of law,” and similarly that plaintiffs “have not demonstrated a reasonable doubt that Eisner was disinterested in granting Ovitz a Non-Fault Termina-

lion in income realized so far.”).

206 This was the same board that one survey assessing standards of corporate governance labeled the worst in the nation. John A. Byrne, *The Best and Worst Boards*, BUS. WK., Dec. 8, 1997, at 90 (“Disney’s directors have won the dubious distinction of being named the worst board in America in Business Week’s second annual analysis of the state of corporate governance. Institutional investors and boardroom watchers scorn what they see as a meek, handpicked group, many of whom have long ties to Eisner or the company.”); see also Robert W. Lear & Boris Yavitz, *The Best and Worst Boards of 1995: Evaluating the Boardroom*, CHIEF EXECUTIVE, Nov. 1995, at 24 (rating boards on basis of corporate governance principals and stating that Disney has one of the “worst boards”).

207 Despite the summary treatment of the issue, the trial court had sufficient reservations to treat Eisner as interested and to analyze the independence of the board. *In re The Walt Disney Co. Derivative Litig.*, 731 A.2d at 354–55.

208 *Id.* at 355.

209 The plaintiffs were forced into arguing that Eisner somehow benefited financially from the transaction. *Id.*

210 See *Brehm v. Eisner*, 746 A.2d 244, 257 (Del. 2000) (“The facts supporting plaintiffs’ claim that the New Board was not disinterested or independent turn on plaintiffs’ central allegation that a majority of the Board was beholden to Eisner. It is not alleged that they were beholden to Ovitz. Plaintiffs’ theory is that Eisner was advancing Ovitz’ interests primarily because a lavish contract for Ovitz would redound to Eisner’s benefit since Eisner would thereby gain in his quest to have his own compensation increased lavishly. This theory appears to be in the nature of the old maxim that a ‘high tide floats all boats.’ But, in the end, this theory is not supported by well-pleaded facts, only conclusory allegations.” (footnotes omitted)).

tion.” Plaintiffs challenge this conclusion, but we agree with the Court of Chancery and we affirm that holding.²¹¹

Both courts rendered their decisions without allowing plaintiff to engage in discovery to explore the relationship. In other words, the courts found that the evidence did not even present “reasonable doubt” about the relationship between Ovitz and Eisner.

In the ordinary course of things, that would be the end. To guess what might have been uncovered had discovery proceeded would be a matter of speculation. But, of course, there was nothing ordinary about *Disney*. It continued, culminating in a lengthy trial with a voluminous record and a second appeal to the Delaware Supreme Court. The relationship between the two Michaels also became the subject of a high profile book. From these sources, considerable additional information about the relationship surfaced, including that:

- The two had been “close” friends for nearly a quarter of a century²¹² and “were very well acquainted, both socially and professionally;”²¹³
- Ovitz was Eisner’s closet friend in Hollywood;²¹⁴
- The wives of the two men were best friends;²¹⁵

211 *Id.* at 258 (footnotes omitted). With Eisner not having an interest in the outcome of the transaction, there was no interested influence on the board and no reason to examine the independence of the rest of the board. *Id.* (“[W]e hold that the Complaint fails to create a reasonable doubt that Eisner was disinterested in the Ovitz Employment Agreement, we need not reach or comment on the analysis of the Court of Chancery on the independence of the other directors for this purpose.”).

212 *See Brehm v. Eisner*, 906 A.2d 27, 36 (Del. 2006) (“Eisner and Ovitz had enjoyed a social and professional relationship that spanned nearly 25 years.”). The same court that refused to allow discovery into the closeness of the relationship noted on four occasions in a later opinion the closeness of the relationship and the fact that it lasted twenty-five years. *See In re The Walt Disney Co. Derivative Litig.*, 825 A.2d 275, 279 (Del. Ch. 2003) (Ovitz “had, however, been Eisner’s close friend for over twenty-five years.”). The disingenuousness of the approach forced an explanation. *Id.* at 287 n.30 (“The allegation that Eisner and Ovitz had been close friends for over twenty-five years is not mentioned to show self-interest or domination. Instead, the allegation is mentioned because it casts doubt on the good faith and judgment behind the Old and New Boards’ decisions to allow two close personal friends to control the payment of shareholders’ money to Ovitz.”).

213 *In re The Walt Disney Co. Derivative Litig.*, 907 A.2d 693, 699 (Del. Ch. 2005), *aff’d sub nom. Brehm*, 906 A.2d 27. Appellants’ brief described them as “life partners.” Appellants’ Opening Brief at 8, *In re The Walt Disney Co. Derivative Litig.*, 907 A.2d 693, 699 (Del. Ch. 2005).

214 JAMES B. STEWART, *DISNEY WAR* 37 (Simon & Schuster 2005) (noting that the relationship had existed since before he joined Disney).

215 James B. Stewart, *Partners, Eisner, Ovitz, and the Disney Wars*, *NEW YORKER*, Jan. 10, 2005, at 46, 48.

- The two families vacationed as a group and spent Christmas together in Aspen in 1995;²¹⁶
- Eisner's wife called Ovitz when Eisner unexpectedly had open-heart surgery and Ovitz terminated a planned vacation to come to the hospital;²¹⁷
- Eisner invited Ovitz to be with him and his wife while awaiting the final decision on whether he would be appointed as CEO of Disney;²¹⁸
- Eisner would use effusive terms when writing to Ovitz.²¹⁹ A letter written by Eisner in October 1996 included: "You still are the only one who came to my hospital bed—and I do remember."²²⁰
- Ovitz would use effusive terms when writing to Eisner;²²¹ and
- Ovitz sat on board of the New York Museum of Modern Art with Sid Bass, one of Disney's largest individual shareholders.²²²

In other words, despite the four dismissive sentences by the Delaware courts, the two had cultivated an extraordinarily close personal relationship over a protracted period of time that encompassed their respective families. An examination of their interlocking business relationships would no doubt have added to the plaintiffs' showing of the strength of the relationship. Most of the information, however, was not in the public domain and was only uncovered by the sleuth of an author and the compulsion of a trial.²²³

216 *Id.* at 54.

217 STEWART, *supra* note 214, at 175 (noting that Ovitz came and "took charge, which seemed to come as a relief to Jane [Eisner's wife]."). Appellants' brief described him as having "guarded" the hospital room. Appellants' Opening Brief, at 8, *In re* Walt Disney Derivative Litig., 907 A.2d 693 (Del. Ch. 2005).

218 STEWART, *supra* note 214, at 54–55.

219 STEWART, *supra* note 214, at 200 (noting that Eisner wrote in a letter to Ovitz "the thank-you note Ovitz had written after their first trip to Disney World has so moved him that he'd carried a copy of the letter with him ever since.").

220 *Id.* at 56.

221 *Id.* at 60 (noting that Ovitz wrote in a letter "how much we love your family and enjoy the friendship").

222 *Id.* at 65; *see also* Brehm v. Eisner, 906 A.2d 27, 39 n.10 (Del. 2006) (describing Bass as one of largest individual shareholders of Disney).

223 In fact, the failure to permit greater examination of the relationship and the independence of the board likely resulted in some bad law. Without an interested Michael Ovitz or a board that he controlled, the courts could not apply a duty of loyalty analysis to the transaction. Thus, the board was never asked to demonstrate the fairness of the contract. Instead, the courts were left with the duty of care and good faith. The result was a decision that tried to squeeze the board's behavior into the duty of good faith by characterizing the facts in the complaint as amounting to deliberate neglect. *See In re* The Walt Disney Co. Derivative Litig., 825 A.2d 275, 278 (Del. Ch. 2003). The result was a confusion of the duties to be informed under the business judgment rule, *see* Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1984), and good

By summarily dismissing the allegations of friendship, the courts eliminated any possible claim that the contract violated the duty of loyalty. As a result, the burden remained on the plaintiffs to show a breach of the duty of care, an all but insurmountable task, as they learned. The court resolved these intensely factual issues without allowing for discovery.²²⁴ Had the court allowed discovery on the relationship between the two Michaels and appropriately decided the case under the duty of loyalty, the issue would have turned on the fairness of Ovitz's employment contract, with the burden on the board. This would have resulted in a proceeding that centered around the substance of the agreement rather than the minimum level of board attention permissible under the duty of care. In this long and voluminous litigation, the fairness of the agreement was never seriously examined.

VI. NECESSARY CORRECTIONS

Notwithstanding the uncertain value the market places on independence,²²⁵ Delaware has chosen to extend judicial protection to decisions approved by boards consisting of a majority of independent directors. They do so out of the ostensible belief that such approval dissipates the taint of the conflict of interest or is mandated by statute. As has been discussed, this is simply wrong.²²⁶ Section 144(a) requires no such thing. Moreover, the conflict is

faith. *See Brehm*, 906 A.2d 27 (discussing the issue). The case should have been treated under the duty of loyalty, with fairness the operative issue for the litigation to resolve.

224 Following discovery and a trial, the chancery court would all but take a contrary view. "[T]he board's collective kowtowing in regard to Ovitz's hiring is also due to Eisner's desire to surround himself with 'yes men' and nonemployee directors with 'sycophantic tendencies.'" *In re The Walt Disney Co. Derivative Litig.*, 907 A.2d 693, 761 n.488 (Del. Ch. 2005), *aff'd sub nom. Brehm*, 906 A.2d 27; *see also id.* at 760-61 ("Eisner stacked his (and I intentionally write 'his' as opposed to 'the Company's') board of directors with friends and other acquaintances who, though not necessarily beholden to him in a legal sense, were certainly more willing to accede to his wishes and support him unconditionally than truly independent directors." (footnote omitted)).

225 There has been considerable debate on this topic. *See generally* Sanjai Bhagat & Bernard Black, *The Non-Correlation between Board Independence and Long-Term Firm Performance*, 27 IOWA J. CORP. L. 231 (2002); *see also* Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521, 1592-93 (2005). It is of course a common sense notion that independence alone, without consideration of other factors such as intelligence, experience, and force of personality, would not automatically improve the quality of the board. *See supra* note 82.

226 This is true no matter how many times someone on the court says otherwise. *See* Leo E. Strine, Jr., *The Delaware Way: How We Do Corporate Law and Some of the New Challenges We (and Europe) Face*, 30 DEL. J. CORP. L. 673, 678 (2005) ("Delaware tries to respect the business judgment of disinterested directors and stockholders. How? By invoking the protection of the business judgment rule if an interested transaction is approved by a majority of the independent directors or by a majority of the disinterested stockholders, after full disclosure. The idea, of course, is that the investment of ultimate power over the transaction in impartial directors

allowed to remain in the decision-making process, potentially influencing the final resolution.

Moreover, the test for independence and the restrictive (indeed, in some cases, impossible) pleading standards all but ensures that these “independent” majorities will in at least some instances not be independent at all.²²⁷ The result is that the almost insurmountable presumption of the business judgment rule applies to transactions approved by interested boards. Therefore, in the context of the duty of loyalty, fairness no longer matters.²²⁸

The weaknesses of the Delaware approach have already resulted in considerable intervention by regulators. The self-regulatory organizations have opted for a more objective and categorical standard of independence.²²⁹ Sarbanes-Oxley²³⁰ contains one of the toughest definitions of independence, prohibiting directors on the audit committee from receiving any compensation (other than fees), whether direct or indirect.²³¹ And unlike Delaware, the SROs impose quantitative requirements on the number

or stockholders suffices to police the conflict. By this instrumental means, Delaware law can protect the resulting business decision without any loss of integrity, because the decision was made or ratified by persons whose interests were aligned with those of the corporation and its stockholders.”).

227 And, of course, even those directors who meet some kind of reasonable standard of independence may still favor management. *See* Velasco, *supra* note 14, at 842 (“Disinterested directors may not have a financial interest in the transaction in question, but they may nevertheless be conflicted with respect to the decision itself, if only because of its effect on a colleague. The concept of structural bias suggests that too much deference is inappropriate because of such conflict.”).

228 The result is that a transaction viewed as unfair will be considered valid. This was too much for the drafters of the ALI standard. Their formulation required that the transaction fall within the “range of reasonableness.” AM. LAW INST., PRINCIPLES OF CORPORATE GOVERNANCE § 5.02(a)(2)(A) cmt. (1994).

229 The NYSE eschews a subjective definition, instead favoring categorical standards. Under the NYSE definition, for example, any director employed by the company during the prior three years is not independent. *See* N.Y.S.E., INC., CORPORATE GOVERNANCE RULES § 303A(b) (2004). Delaware has no similar rule. Similarly, a director loses his or her independence upon receiving \$100,000 or more during any twelve-month period in the prior three years. The subjective importance of the payment to the director does not matter. In the case of indirect payments, a director who is an executive officer of another company that receives the greater of \$1 million or two percent of consolidated gross revenues will not be independent. The test does not apply in the case of contributions to charities as long as the contributions are disclosed. *See id.*

230 Section 301 of Sarbanes-Oxley requires that directors serving on the audit committee of public companies be independent, a definition that prohibits the acceptance of “any consulting, advisory, or other compensatory fee from the issuer.” 15 U.S.C. § 78j-1 (2005). Thus, Congress expressly rejected the subjective materiality test used by the Delaware courts.

231 For a discussion of Sarbanes-Oxley and the preemptive effect on traditional areas of state regulation, see Brown, *supra* note 25, at 336–38.

of independent directors who serve on the board and important board committees.²³²

None of these definitions or requirements apply to the states,²³³ leaving the standard for approval of conflict of interest transactions unaffected.²³⁴ Delaware, therefore, continues to provide legal benefits to approval by boards dominated and controlled by “interested” directors.²³⁵

Adopting a more consistent application of the definition—one that truly recognizes the full variety of influences that can affect independence—would be a step in the right direction. So would reasonable pleading standards or at least the right to discovery on the issue of independence.²³⁶ These approaches would effectively disqualify as independent a wider array of directors, particularly close friends and those with financial connections unknown to the public.

Theoretically, the approach ought not cause significant concern. It would ensure greater board independence, a recognized goal.²³⁷ Regard-

232 See N.Y.S.E., INC., CORPORATE GOVERNANCE RULES § 303A.01 (2004) (requiring that a majority of the board consist of independent directors); see also Bhagat & Black, *supra* note 225, at 266 (“A third possibility is that some directors who are classified as independent are not truly independent of management because they are beholden to the company or its current CEO in ways too subtle to be captured in customary definitions of independence.”). The inclusion of a definition of independence in Sarbanes-Oxley represents another example of the race to the bottom and the need for federal intervention to impose meaningful requirements. See Lucian A. Bebchuk & Assaf Hamadani, *Federal Corporate Law: Lessons from History*, 106 COLUM. L. REV. (forthcoming 2006).

233 Having said that, Delaware courts refer to them when useful in dismissing an independence challenge. See *In re J.P. Morgan Chase & Co. S’holder Litig.*, 906 A.2d 808, 823 (Del. Ch. 2005) (discussing director Bossidy). At least one commentator has described Delaware law in this area as “[f]ar more important than federal law . . . for purposes of internal corporate governance.” Donald C. Clarke, *Setting the Record Straight: Three Concepts of the Independent Director*, 32 DEL. J. CORP. L. (forthcoming 2006) (manuscript at 23, available at <http://ssrn.com/abstract=892037>).

234 See Fairfax, *supra* note 158, at 415 (“Sarbanes-Oxley does not appear to preempt state law’s treatment of director independence in any meaningful manner. States have the discretion to determine the qualifications of directors and to assess whether directors should be viewed as independent.”).

235 Ultimately, without reform at the state-law level, this represents another area susceptible to federal preemption. Some have contended that reform in Delaware is not explained by a race with other states, but by concern over federal intervention. See Mark J. Roe, *Delaware’s Competition*, 117 HARV. L. REV. 588 (2003) (noting that the pressure for reform in Delaware comes not from other states but from the fear of intervention by the federal government). Perhaps the concern over intervention explains the Delaware Supreme Court’s belated recognition in *Beam* that personal relationships can deprive a director of his or her independence.

236 Gelb, *supra* note 35, at 144 (“If Delaware really wanted the plaintiff to have a fair opportunity to determine the truth about a director’s relationship to a defendant, it would allow at least discovery limited to that issue.”).

237 Thus, for example, the Business Roundtable has recommended that a “substantial majority” of the board consist of independent directors. See Marianne M. Jennings, *A Primer*

less, state law does not require the use of independent directors; it merely provides legal advantages to those companies that employ them.²³⁸

Practically, however, any change is likely to generate a hue and cry.²³⁹ The truth is that management in at least some cases does not want truly independent directors deciding matters involving conflicts of interest.²⁴⁰ These directors are likely to be less deferential to the CEO, perhaps affecting salary decisions or other areas involving self-interest.²⁴¹

Given the inherent difficulty in ensuring independence, it is the director selection process that provides the greatest potential for ensuring neutral decision-makers on the board.²⁴² This could occur, for example, by

on Enron: Lessons From A Perfect Storm of Financial Reporting, Corporate Governance and Ethical Culture Failures, 39 CAL. W. L. REV. 163, 206 n. 207 (2003). The Business Roundtable is “an association of chief executive officers of leading U.S. companies with over \$4.5 trillion in annual revenues and more than 10 million employees.” See Business Roundtable, About Business Roundtable, <http://www.businessroundtable.org/aboutUs/index.aspx> (last visited Oct. 24, 2006).

²³⁸ Public companies traded on an exchange must, of course, have a majority of directors that meet the definition of the relevant SRO. See *supra* note 232 and accompanying text. Under state law, however, there is no requirement of independent directors. See DEL. CODE ANN. tit. 8, § 141(b) (2006) (noting that certificate of incorporation or bylaws “may prescribe other qualifications for directors.”); see also Donald C. Clarke, *Setting the Record Straight: Three Concepts of the Independent Director*, 32 DEL. J. CORP. L. (forthcoming 2006) (manuscript at 26, available at <http://ssrn.com/abstract=892037>) (“But state corporate law in the United States generally leaves this up to corporations themselves to decide; a corporation can have many, few, or no independent directors, and investors can make their own decisions about whether to invest.”).

²³⁹ Tougher standards under state law would increase the risk of director liability. With respect to violations of the rules/listing standards of the SROs, courts have generally concluded that there is no private right of action. See J. ROBERT BROWN, JR., THE REGULATION OF CORPORATE DISCLOSURE § 3.06 (3d ed. 1994 & Supp. 2004).

²⁴⁰ Thus, directors on the compensation committee may have some type of relationship or friendship with the CEO and still qualify as independent. In the context of Worldcom, four of the directors were dubbed “Bernie’s Boys” (as in friends of the former CEO Bernie Ebbers). One of them was on the compensation committee. Steve Rosenbush, *The Ebbers Trial’s Stars and Extras*, BUS. WK. ONLINE, Jan. 25, 2005, <http://www.businessweek.com>. From a state law perspective, however, they were likely considered independent. See also Rachel A. Fink, Note, *Social Ties in the Boardroom: Changing the Definition of Director Independence to Eliminate “Rubber-Stamping” Boards*, 79 S. CAL. L. REV. 455, 480–82 (2006) (discussing presence of friends of CEO Conrad Black on the board of directors of Hollinger International).

²⁴¹ Or, as Marty Lipton, one of the premier corporate lawyers in America, put it: “Boards of directors, while independent in name, were not really independent and did not act as independent monitors of management.” Martin Lipton, Address at the Commercial Club: Bubbles and Their Aftermath (Nov. 2002) (transcript available at http://www.thecorporatelibrary.com/special/misc/700626_4.pdf). Similarly, while the Delaware courts considered the Disney board to be independent as a legal matter, at least some in the market disagreed as a practical matter. See *supra* note 206.

²⁴² It would likely ensure not only independence but the other qualities necessary for effective oversight. See *supra* note 82; see also Lucian Arye Bebchuk, *Corporate Governance: Directors vs. Shareholders?: The Case for Shareholder Access: A Response to the Business Roundtable*,

facilitating nominations by non-management shareholders.²⁴³ These directors would presumably have a greater likelihood of remaining independent of the CEO and avoiding the problem of “structural bias.”²⁴⁴ Unsurprisingly, Delaware, as well as the Securities and Exchange Commission,²⁴⁵ has made this difficult by allowing companies to impose restraints on share-

55 CASE W. RES. L. REV. 557, 562 (2005) (“Although the recent strengthening of director independence might well be beneficial, it does not obviate the need for the safety valve of a viable mechanism for shareholder replacement of directors. The mere independence of directors from insiders ensures neither that directors are well selected nor that they have the right incentives to advance shareholder interests.”). The NYSE has moved in this direction by requiring that listed companies have nominating committees consisting entirely of independent directors. See N.Y.S.E., INC., CORPORATE GOVERNANCE RULES § 303A (2004). Moreover, the SEC has required disclosure of the method used in identifying nominees. See Item 7, Schedule 14A, 17 C.F.R. § 240.14a-101 (2006). In effect, both reforms attempt to reduce the influence by the CEO on the nomination process. Some anecdotal evidence indicates this is having an effect. See Alan Murray, *Leash Gets Shorter for Beleaguered CEOs*, WALL ST. J., Aug. 23, 2006, at A2 (“The firing of a CEO used to be a rare event—even the worst of them often managed to cling to power with remarkable tenacity. In the past two years, however, CEO firings have become common place.”). Of course, the approach does not apply to all companies, relies on the NYSE definition of independent, and does not prevent the CEO from making recommendations to the committee. While a step in the right direction, therefore, it is not likely to ensure that truly independent directors sit on the board.

243 Shareholders can, of course, already nominate directors. The difficulty arises in the costs associated with their election. Roberta S. Karmel, *Realizing the Dream of William O. Douglas—The Securities and Exchange Commission Takes Charge of Corporate Governance*, 30 DEL. J. CORP. L. 79, 123 (2005) (“There is nothing to prevent any shareholder from nominating a director in opposition to a director nominated by a current board, though it can be a costly endeavor.”). Commentators have suggested that the costs of electing shareholder nominees be born by the company, at least in some cases. See Lucian A. Bebchuk & Marcel Kahan, *A Framework for Analyzing Legal Policy Towards Proxy Contests*, 78 CAL. L. REV. 1073, 1135 (1990).

244 See Paredes, *supra* note 149, at 761 (“It is reasonable to assume that a shareholder nominee who is elected to the board will be more responsive to shareholders and more willing to challenge the CEO, as well as other senior managers and directors.”).

245 See 17 C.F.R. § 240.14a-8(i)(8) (2006) (prohibiting shareholders from submitting proposals that “relate[] to an election for membership on the company’s board of directors”). The Second Circuit, however, rejected the agency’s interpretation that the provision precluded proposals to amend the bylaws and permit shareholder nomination of directors. See *Am. Fed’n of State, County & Mun. Employees, Employees Pension Plan v. Am. Int’l Group, Inc.*, 462 F.3d 121, 123 (2d Cir. 2006). This is not the first time the courts have had to remind the Commission of the investor protection nature of the shareholder proposal rule. See *Med. Comm. For Human Rights v. SEC*, 432 F.2d 659, 680–81 (D.C. Cir. 1970) (stating the primary purpose of section 14(a) is to protect investors), *vacated as moot*, 404 U.S. 403 (1972). In fairness, the SEC did propose rules that would have permitted shareholder nominations, see *Security Holder Director Nominations*, Exchange Act Release No. 48626, Investment Company Act Release No. 26206, 81 S.E.C. Docket 770 (Oct. 14, 2003), and increased the disclosure of the director nomination process. See *Disclosure Regarding Nomination Committee Functions & Communications Between Security Holders & Boards of Directors*, Securities Act Release No. 8340, Exchange Act Release No. 48825, Investment Company Act Release No. 26262, 81 S.E.C. Docket 2135 (Nov. 24, 2003). The shareholder nomination rules were never adopted. The disclosure rules are not likely to be particularly effective. See J. Robert Brown, Jr. & Celia R. Taylor, *A Seat at the Board*, TEX. LAW., May 3, 2004, at S10.

holder nominations.²⁴⁶ To the extent that this continues, it is another area ripe for federal preemption.²⁴⁷

Facilitating nominations will not ensure election.²⁴⁸ Another alternative might be to require the inclusion of shareholder nominees in management's slate of directors.²⁴⁹ Committees representing shareholders could, for example, be given the right to designate a specified number of nominees.²⁵⁰

Courts also need to abandon the characterization of a majority independent board as "neutral" for purposes of eliminating fairness and the application of the business judgment rule. Neutrality is not a rote process of counting directors, with a majority the automatic tipping point. Neutrality is a process of ensuring the absence of the interested influence. The presumption should, therefore, go the other way. To the extent interested influence remains a part of the decision making process, the presumption should be that the board is not neutral. The burden should be on the board to show otherwise by, for example, using a special committee consisting entirely of independent directors.

246 Delaware courts have approved of bylaws designed to restrict the ability of shareholders to nominate directors. *See* *Stroud v. Grace*, 606 A.2d 75, 95–96 (Del. 1992); *see also* *Acciptier Life Scis. Fund, L.P. v. Helfer*, 905 A.2d 115, 126–27 (Del. Ch. 2006) (refusing to grant relief to shareholders who wanted to nominate directors where bylaws gave them 10 days after announcement of meeting date and announcement buried in earnings press release).

247 *See supra* note 235.

248 China permits shareholder nominations but does not ensure that those nominated will be elected. *See* Donald C. Clarke, *The Independent Director in Chinese Corporate Governance*, 31 DEL. J. CORP. L. 125, 196 (2006) ("Yet it is far from clear how this requirement would play out in elections of independent directors."). The corporate code in Israel requires the presence of two "outside" directors on the boards of public companies. Outside directors must receive at least one-third of all votes not cast by controlling shareholders. *See* Yael T. Ben-Zion, *The Political Dynamics of Corporate Legislation: Lessons from Israel*, 11 FORDHAM J. CORP. & FIN. L. 185, 271 (2006).

249 Slight movement has occurred in this direction. The SROs require a nominating committee consisting of independent directors. *See* N.Y.S.E., INC., LISTED COMPANY MANUAL § 303A.04(a) (2003). The SEC requires disclosure in the proxy statement of any "policy with regard to the consideration of any director candidates recommended by security holders." 17 C.F.R. § 240.14a-101(Item 7)(d)(2)(ii)(E) (2006).

250 For a discussion of this approach, see George W. Dent, Jr., *Corporate Governance: Still Broke, No Fix in Sight*, 31 J. CORP. L. 39, 67 (2005).

Using a truly neutral decision-making body still begs the question of the appropriate standard of review. As courts,²⁵¹ commentators,²⁵² the ALI,²⁵³ and common sense recognize, it is never entirely possible to dissipate the taint of the conflict from the decision-making process.²⁵⁴ Application of the business judgment rule eliminates any consideration of fairness despite the obvious possibility that the transaction may be motivated by a desire to aid the interested director.

At the same time, benefits should accrue to a decision-making process that relies on truly independent directors. Doing so would leave to the board, rather than the courts, the determination of those conflict of interest transactions that benefit the company. Rather than apply the business judgment rule, which presupposes a complete absence of a conflict of interest, neutral approval should only shift to the plaintiffs the burden of showing the unfairness of the transaction. This is the standard already used by the Delaware courts in the context of controlling shareholders.²⁵⁵ Such a

251 See *Shlensky v. S. Parkway Bldg. Corp.*, 166 N.E.2d 793, 800 (Ill. 1960) (holding that disinterested approval shifts burden of establishing fairness); see also *Sobek v. Stonitsch*, 995 F.Supp. 918, 922 (N.D. Ill. 1998). Other courts have found that disinterested approval merely shifts the burden. See *Sullivan v. Easco Corp.*, 656 F.Supp. 531, 535 (D. Md. 1987).

252 Bratton, *supra* note 62, at 1088–89 (“To accord this process anything approaching preclusive legal effect, however, threatens the integrity of the norm of selfless conduct. Disinterested directors, as colleagues of the interested directors, often approach self-dealing transactions in a spirit of accommodation.”); see also Melvin Aron Eisenberg, *Self-Interested Transactions in Corporate Law*, 13 J. CORP. L. 997, 1002 (1988) (stating that Eisenberg has cautioned that “directors, by virtue of their collegial relationships, are unlikely to treat one of their number with the degree of wariness with which they would approach a transaction with a third party.”).

253 Section 5.02 of the ALI formulation provides an intermediate standard. With approval by disinterested shareholders, plaintiff must show that the disinterested directors “could not reasonably have concluded that the transaction was fair to the corporation at the time of its authorization.” As the comment to the section explained: “[I]f a transaction between a director or a senior executive and the corporation is authorized in advance by disinterested directors (or in the case of a senior executive who is not a director, by a disinterested superior), then a person attacking the transaction has the burden of proving not simply that the transaction is unfair, but that the terms of the transaction are so clearly outside the range of reasonableness that the directors or disinterested superior who authorized the transaction could not reasonably have concluded at the time of such authorization that the transaction was fair to the corporation.” Although intermediate, some have characterized the standard as closer to the business judgment rule than fairness. See Marleen A. O’Connor, *How Should We Talk About Fiduciary Duty? Directors’ Conflict-of-Interest Transactions and the ALI’s Principles of Corporate Governance*, 61 GEO. WASH. L. REV. 954, 958 (1993) (concluding that ALI standard is closer to business judgment rule); see also Bratton, *supra* note 62, at 1089 (“Their new standard of scrutiny—reasonableness review of the directors’ fairness determination—imports stricter scrutiny than would the business judgment rule, but also purports to block full fairness review by the courts.”).

254 See *supra* notes 80–81, 93–94, and accompanying text.

255 See *supra* notes 65–69.

standard will continue to make the terms of the transaction relevant but at the same time provide heightened protection to boards.

VII. CONCLUSION

Whatever the solution, the problem is clear. Delaware courts have employed an approach that accords enormous deference to decisions by boards that are not independent. The direct consequence has been the repeal of the fairness requirement for transactions involving conflicts of interest. Courts instead apply the business judgment rule, rendering the actual terms of the transaction irrelevant.

All of this leads to a prediction: because they can, boards will continue to avoid exercising significant control over self-interested transactions. Executive salaries will continue to escalate. Insiders will continue to obtain excessive benefits and highly favorable terms. And when the abuses become sufficiently severe, Congress will step in and override the state legal regime.

