Delaware Rules

Heated debates over governance, director independence, and executive pay will likely be resolved in Delaware's Chancery Court.

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Reporters descending on the hamlet of Georgetown for The Walt Disney Co.'s Delaware Court of Chancery trial poked fun at the Mayberry-like setting. In *Vanity Fair*'s February 2005 account of the shareholders' star-studded battle to recover the $130 million severance paid to president Michael Ovitz — a settlement pushed through a compliant Disney board by then-CEO Michael Eisner — Dominick Dunne tweaked the "one-street town two hours from Wilmington." Chancellor William B. Chandler III struck Dunne as "a very classy guy, who keeps a bike in the courthouse" and whose local restaurant suggestions "were right on the money."

The chancellor's 180-page opinion last August, *In Re The Walt Disney Co.*, put an end to the lighthearted commentary. Chandler lambasted Eisner for having "enthroned himself as the omnipotent and infallible monarch of his personal Magic Kingdom," and ticked off a series of Disney blunders that fell "significantly short of the best practices of ideal corporate governance." Still, Chandler ruled that Eisner and the board had made their mistakes in good faith, availing them of the protection of what the jurist calls Delaware's "bedrock": the business-judgment rule. (The rule shields companies, directors, and officers from liability — including the ruling of personal liability that the Disney shareholders sought — as long as they act within "the duty of care and the duty of loyalty," the twin components of good faith.)

"Being in Delaware doesn't mean it's small-town. The Court of Chancery is the country's business court," notes Charles Elson, Edgar S. Woolard Jr. chair of corporate governance at the University of Delaware. More than half of America's publicly traded businesses are incorporated in Delaware and thus covered by its statutes, and the court's precedents are frequently adopted in other states.

Across America, directors of companies "breathed a sigh of relief" when the Disney decision was issued, says Beth I. Z. Boland, a partner in the Boston law firm of Bingham McCutchen LLP.

But Chandler is thinking ahead. Struck by the "heightening of tension in the relationship between shareholders and management, and shareholders and the board of directors," he is gearing up to preside over a period of legal history-making he expects to rival the court's last landmark era — two decades ago, during the corporate-takeover craze, when the court worked out ground rules for mergers and acquisitions and poison pills.

Today, the chancellor envisions a proliferation of cases focusing on executive compensation, director independence, and the role that shareholders can have in governance determinations. Questions are already being asked about whether shareholders can adopt bylaws that trump board decisions. "And then when they do, if they have that power, can the board of directors

then turn around and negate or change the bylaw?" he asks. "That issue has never been directly faced or answered in Delaware, but I think it's inevitable that it will be decided."

What Chancery rulings say in the near future could establish standards that rival anything that Sarbanes-Oxley and the Securities and Exchange Commission have offered. "Delaware state law governs corporate conduct. It drives best practices," points out Elson. And while the court must wait for cases to be brought before it — unlike regulators that can aggressively root out impropriety — "ultimately the Delaware Chancery Court will have a significant role in changing governance," he says.

Differences of Opinion

What changes may be wrought in Chancery's courtroom remain to be seen. Some rights advocates fear that the court will keep shareholders on the sidelines. "I have this concern that too often their allegiance is to the company management," says Nell Minow, co-founder of The Corporate Library, a corporate-governance research group based in Portland, Maine.

Such concern may be grounded in opinions like *In Re Disney*, which, despite Chandler's scolding, was still a victory for Disney's board. A recent critique of the Chancery Court in *The Deal* noted that the Delaware Supreme Court reversed no fewer than five Chancery Court decisions in 2002 and 2003, decisions that had affirmed the actions of a corporate board. The magazine interpreted the reversals as a signal to the lower court that it needed to be tougher on business in the post-Enron era.

But Chandler scoffs at the notion that he was sent a message, and disagrees with the assessment that reversals have toughened up this court. "In my view, the 2002–2003 reversals were not that significant," he says, and "were not a signal of a more stringent standard of review or scrutiny in the post-Enron era. They were fact-specific reversals, rather than broad pronouncements heralding a new enhanced scrutiny of corporate decision-makers."

Chandler says that court watchers "sometimes overemphasize the significance of reversals, viewing them as markers for a shift or change in the direction of Delaware corporate law." That's not how Delaware courts work, he says. Chancery Court jurists are appointed for 12-year terms, he points out, and are protected from political winds.

According to Elson, though, Chancery has moved steadily in the investor's direction. "Traditionally, the court's view was that shareholders were not sophisticated and needed to be protected from their own foolishness," he says. "Today what they need to be protected from is managerial overreaching" (see "A Delaware Dozen" at the end of this article).

Declarations of Independence

It is common for Delaware's jurists to explain their rulings as incremental and following precedent, rather than marking a dramatic shift. Yet judges agree with both sides of the bar on one point: that the current focus on shareholder-related litigation is likely to reshape corporate governance.

One area is establishing standards for director independence, critical because the current board model provides for domination by nonmanagement directors, in part so that they can man the required independent committees. Clear guidelines on independence also help assure prospective board members that they won't face oppressive personal liability.

Attorney Boland believes she saw a "seismic shift" toward tougher independence standards in a 2003 Chancery ruling, *In Re Oracle Corp.*, that refused to dismiss an Oracle shareholder suit. The plaintiffs had charged that a special litigation committee of Oracle's board, named to investigate stock trades made by Oracle executives, was not sufficiently independent. The committee had concluded that the executives had no material nonpublic information before they initiated the trades.

In his ruling, Vice Chancellor Leo E. Strine Jr. noted that because committee members were professors at Stanford University, and three of the four defendants had deep Stanford ties, the committee was not independent. Boland believes the court will now "look beyond quantifiable measures to go into soft issues" in determining who is independent. (But as in the Disney case, the court eventually found for the corporate defendant.)

Strine says his ruling reflected existing standards, not new ones, since the test for special-committee independence traditionally is more exacting than for a director. With questions about director independence likely facing the court again and again, though, Strine's ruling suggests to some that boards will have to examine the relationships among all directors more comprehensively than before.

Finance executives paid special heed to Chancery's 2004 ruling, *In Re Emerging Communications Inc.*, against two directors of Emerging Communications. Vice Chancellor Jack B. Jacobs, now on the state Supreme Court, held a director with "specialized financial expertise" personally liable for damages because he failed to vote against a deal that he knew was unfairly priced.

While the case may have seemed to set a separate liability standard for all directors having finance expertise, Chandler says, "my view is that our law doesn't expect different standards to be applied to different directors based on their expertise, their skill, or their training." The facts suggested that this particular finance expert had abused a close business relationship with the majority owner of a company trying to go private, leading the expert to vote for a low buyout price. Thus, CFOs who sit on boards can feel safe that they won't face additional liability — unless, like any other director, they lose sight of their duty to serve those companies well.

Another question as to whether Chancery Court is breaking new ground arose recently in *UniSuper Ltd.* v. *News Corp.* That case was brought by shareholders after Rupert Murdoch's media company — reincorporating in Delaware from Australia — reneged on a promise it made to modify a poison pill only if it got shareholder approval. The real problem came when Chandler, who this time ruled for the shareholders and required News Corp. to modify the pill, described board members as "agents" of the stockholders. In a magazine article, three partners of law firm Wachtell, Lipton, Rosen & Katz countered that "any such 'directors are agents' theory is contrary to statute, contrary to controlling Delaware precedent, bad for shareholders, and completely impractical as a corporate-governance regime."

Responds Chandler, "I'm not really troubled that I have signaled any sea change of significant departure in Delaware law." He was referring to "agency principles as a way of trying to rebut an argument by the defendant that the board was free at any point to enter into a contract with shareholders, and then reject it." Chandler argues that it "would be a strange thing to invoke your fiduciary duties as a sword to break a contract that you had made with shareholders."

"Deconstructing American Business"
Wachtell Lipton's Martin Lipton, the inventor of the poison-pill defense in the 1980s, worries too about the impact if Delaware courts rule for Harvard University professor Lucian Bebchuk in a current case. As a shareholder of CA Inc., Bebchuk is suing the company as part of a campaign to get companies to allow binding stockholder votes. His proposal would let shareholders change antitakeover provisions of company bylaws to require a unanimous vote of directors and force poison pills to expire after one year, unless holders approve their extension. Some companies approved similar proposals from Bebchuk, but CA responded that the amendment violates Delaware law.

In a law-firm newsletter item titled "Deconstructing American Business," Lipton and fellow attorney Mark Gordon argued that Bebchuk's proposals "embed corporate policy directly into the targets' constitutional documents and increase shareholder power while reducing or neutralizing the role of the board of directors in safeguarding the interests of the corporation." The attorneys called the changes part of "a shareholder-centric governance model that is at odds with the fundamental construct of our corporate law."

Michael Barry, who represents Bebchuk through the Wilmington-based law firm Grant & Eisenhofer PA, counters that "for years the corporate bar and the boards of directors have perpetuated a misunderstanding of Delaware law that directors are given some unfettered discretion in the way they manage the corporation." He says the suit gives Chancery Court an opportunity to rule that a corporate office or directorship is "not a managerial right, but a privilege." Vice Chancellor Stephen P. Lamb ruled in mid-June that the issue was not yet "ripe" for a decision, but left the case open. That led CA to decide to place the proposal before shareholders at its annual meeting later this month.

Meanwhile, Chandler wonders whether Bebchuk, who has written extensively and critically on executive pay, would give shareholders a say on compensation matters. "The board is ultimately going to have to decide compensation for executives," he says, "but could shareholders adopt bylaws that place limitations or constraints in either the scope or magnitude of that compensation, or on the procedures that boards must follow before it awards compensation to a particular executive?"

Compensation on Trial
Strine predicts that compensation-related matters will indeed find a place on the docket. "If you overpaid somebody by $100,000, who would bring that case?" he asks. But today, "if you can prove that this person was overpaid by $15 million, then there might be something good in it for the client, and enough to justify the cost of litigation."

Usually, an issue like compensation "is the last thing courts would want to get into, since the board is the boss of the CEO and has a duty to do that," says Strine. But, he adds, "to the extent that boards have been breaching their duty, it's always theoretically been a cause of action."

Northeastern University professor Donald Margotta doubts that Chancery Court will overrule board judgments on CEO pay, but he sees a possible opening for shareholders if the court increases their bylaw powers. The court will encounter potentially sticky issues expanding those powers, he adds, because of the wide variety of investor motivations — if they also own shares of competing companies, for example, or are interested in a quick cash-out.

Ironically, in any compensation-related case brought in Delaware, plaintiffs are likely to cite language from *In Re Disney*. Charles Elson says that would illustrate perfectly the way the Court of Chancery works. "Delaware doesn't get its jollies holding people liable," he says. "Its message is that 'the next time I see this conduct, I'm likely to rule differently.' It's a delayed impact that defines the parameters of behavior."

Chandler notes that his scathing commentary was intended as "moral suasion" for Disney and others. "The opinion spoke rather bluntly to corporate fiduciaries responsible for executive-compensation issues," he says, and offered "a casebook example of how not to conduct a compensation-committee meeting, or how not to go about establishing an executive's compensation package."

Timing thus is an essential ingredient in Delaware rulings. A board's behavior 10 years ago, which might not have breached the good-faith standard then, may well breach it in today's governance environment. Likewise, a company making a business judgment today that lands it before the Chancery Court won't be second-guessed by the court according to future standards.

How does Chandler answer those who say that the court too often rules in favor of corporate defendants, keeping them from liability? "My answer to that is how come, then, I get attacked on all sides?" he says with a laugh. "Maybe that's the best measure that I'm doing right."

Roy Harris is a senior editor at CFO.

A Delaware Dozen

Two decades of cases marking the Chancery Court's guidance.

1985
Smith* v. *Van Gorkom
Actually an appeal from a Chancery decision, it established that directors can be personally liable for costs to shareholders if the board's judgment is "uninformed." Factors necessary to win directors protection of the business-judgment rule included a deliberate process, proper time spent on the matter, provision of necessary documentation, and third parties called in if necessary.

1985
Unocal* v. *Mesa Petroleum
Held defensive tactics acceptable if they are reasonable in relation to the threat, and if directors don't act "solely or primarily out of a desire to perpetuate themselves in office."

1985
Moran* v. *Household International
Said poison-pill defenses are acceptable in advance of a takeover attempt, and repeal is a matter for shareholders or directors.

1985
Revlon* v. *MacAndrews & Forbes Holdings
Established that when a board concludes that the company's sale is inevitable, directors must become neutral arbiters to ensure that shareholders get the best possible price.

1990
Paramount Communications* v. *Time
Backed a company's right to reject a takeover attempt despite shareholder support of the hostile offer.

1996
In Re Caremark International
Established a board's duty to create compliance mechanisms, or face substantial liability. Showed how directors' roles in complying with the law had expanded.

1998
Carmody* v. *Toll Brothers
Ruled out the dead-hand poison-pill takeover defense, which gave directors unequal power. Shifted court protections away from management, toward shareholders.

2000
Chesapeake* v. *Shore
Continued the trend with a ruling against supermajority antitakeover bylaws as a "preclusive, unjustified impairment" of shareholder voting power. Recognized greater sophistication of large holders and their increased role in corporate governance.

2002
Hewlett* v. *Hewlett-Packard Co.
Supported the Compaq merger, but affirmed the prohibition against "vote-selling" among shareholders, a practice that HP managers were alleged to have encouraged.

2003
In Re Oracle Corp.
Applied tough independence standards to a board's special litigation committee, but has been interpreted by some to suggest that the nature of independence among all directors might be broadened to include quasi-financial relationships.

2005
In Re The Walt Disney Co.
Defined an expanded duty of good faith and suggested that directors who were not independent of management and did not follow appropriate procedures could expose themselves to personal liability.

2006
UniSuper* v. *News Corp.
Recognized that directors' breaking of a verbal commitment to shareholders — in this case to modify a poison pill — could be enforceable against a board.

Sources: Review of Delaware cases; Prof. Charles Elson, University of Delaware

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Protecting the Franchise

Underpinning Delaware's popularity among companies is the unrivaled business-law tradition of the Court of Chancery. It is an institution rooted in the feudal English King's Chapel court, from

which the chancellor would dispense justice to individuals victimized by other courts' procedural rigidity or corruption. Delaware established its court in 1792, and in the industrial age made itself a lucrative magnet for incorporations by combining pro-company tax policy with a procompany legal structure.

"Delaware protects that franchise very carefully," says Charles Elson, a corporate-governance expert at the University of Delaware. It does so by offering what can best be described as a form of legal risk management.

"We strive to maintain the continuity of our law and the cogency of our law," says Chancellor William B. Chandler III, who has been in that post for nine years. "We don't have these weird outlier cases where a jury suddenly awards a huge amount — because we don't have juries. So people can expect the same standards of stability and certainty." — *R.H.*