

## ENHANCED SCRUTINY AND CORPORATE PERFORMANCE: THE NEW FRONTIER FOR CORPORATE DIRECTORS

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Four sentences into his classic work, *The Common Law*, Oliver Wendell Holmes pronounced: "The life of the law has not been logic: it has been experience."<sup>1</sup> Holmes contended that such things as the "felt necessities of the time, the prevalent moral and political theories," and "even the prejudices which judges share with their fellow-men have . . . more to do [with the determination of legal rules] than the syllogism."<sup>2</sup> If the thesis of Holmes' first lecture — ominously titled "Early Forms of Liability" — holds true, a new legal rule may well be in the offing to deal with the subject of director responsibility for corporate performance.

It is, in certain respects, natural that director responsibility for corporate performance has now become a topic of increasing attention. The takeover years of the 1980s and early 1990s may have masked a fundamental malaise in corporate performance. Poor performance — whether in the form of mismanagement, intractable business problems, inferior market perceptions of value, or whatever — was addressed by acquisition.<sup>3</sup> There was little occasion to dilate upon the accountability of directors for poor performance. The focus was brightly put on directors as overlords of the takeover fights, not as managers or stewards of the enterprise. The focus on takeovers in the boardroom blinded all else, including director responsibility and accountability for corporate performance.

At the same time, the takeover years spawned a new infrastructure of stockholder activism that is unlikely to disappear, even if takeover issues recede.<sup>4</sup> The alliances developed by stockholder activists are more than capable of shifting agendas to avoid a vacuum.<sup>5</sup> The technology of the stockholder activists is likewise easily converted from takeover issues to questions of corporate performance. Takeovers gave birth to new forms of stockholder expression and power. These forces are now fully able to push

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<sup>1</sup>OLIVER W. HOLMES, *THE COMMON LAW* 5 (Mark DeWolfe Howe ed., Belknap Press 2d ed. 1963) (1881).

<sup>2</sup>*Id.*

<sup>3</sup>See Joseph A. Grundfest, *Just Vote No: A Minimalist Strategy for Dealing with Barbarians Inside the Gate*, 45 *STAN. L. REV.* 857, 869-70 (1993).

<sup>4</sup>See Charles M. Elson, *Executive Overcompensation—A Broad-Based Solution*, 34 *B.C. L. REV.* 937, 966-67 (1993).

<sup>5</sup>See Martin Lipton, *Corporate Governance in the Age of Finance Corporatism*, 136 *U. PA. L. REV.* 1, 33-35 (1987).

hard on the more fundamental question of responsibility for corporate performance.

On another level, the takeover years spawned subtle, but significant, techniques for adjustment of the legal rules applicable to director responsibility. The classic business judgment rule and its constituent duties of care and loyalty continued, of course, to provide the vocabulary. The vitality and inherent flexibility of the business judgment rule analysis, however, became increasingly evident in the reformulations that developed in response to corporate takeover issues. Clearly, the legal system no longer applies a unitary business judgment rule that treats all director responsibilities in the same fashion and under the same tests.<sup>6</sup>

The first fundamental shift in business judgment doctrine came with the Delaware Supreme Court's decision in *Unocal Corp. v. Mesa Petroleum Co.*<sup>7</sup> *Unocal* sanctioned a truly radical form of takeover defense — one that inflicted economic harm on the raider in an exclusionary target self-tender by providing additional value for all target shares except those held by the raider.<sup>8</sup> Consequently, the *Unocal* opinion was initially seen as a great and unequivocal victory for target company directors.

In actuality, however, *Unocal* represented a balanced and highly significant restatement of business judgment analysis. The opinion reflected the pressures of corporate takeovers and a deeply-felt view that some greater degree of judicial review was appropriate. Citing the "omnipresent specter" that a besieged target board "may be acting primarily in its own interests," the court broke new ground by announcing an "enhanced duty" that requires "judicial examination at the threshold before the protections of the business judgment rule may be conferred."<sup>9</sup> This "enhanced duty" obliges the directors to show that a danger to corporate policy and effectiveness existed and that the defensive measure adopted was "reasonable in relation to the threat posed."<sup>10</sup>

This shift was far from semantic. While retaining basic business judgment terminology, *Unocal* adjusted the focus in a critical way — simultaneously empowering directors to be forceful and effective in takeover defenses and empowering courts to review, objectively and substantively, those judgments under tests that go well beyond simple assessment of director good faith and the absence of grossly negligent conduct. *Unocal*,

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<sup>6</sup>See Robert J. Klein, Note, *The Case for Heightened Scrutiny in Defense of the Shareholders' Franchise Right*, 44 STAN. L. REV. 129, 147-50 (1991).

<sup>7</sup>493 A.2d 946 (Del. 1985).

<sup>8</sup>*Id.* at 951.

<sup>9</sup>*Unocal*, 493 A.2d at 954.

<sup>10</sup>*Id.* at 955.

therefore, represented a key example of judicial reshaping of legal rules to reflect real world experience.

Much the same type of legal development has formed the legal rules applicable to sales of the corporate enterprise. In *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*<sup>11</sup> and *Mills Acquisition Co. v. Macmillan Inc.*,<sup>12</sup> the Delaware Supreme Court applied the "enhanced duty" analysis more broadly to circumstances in which "issues of corporate control are at stake."<sup>13</sup> Under this extension, the court held directors' conduct in the sale context to be subject to a *Unocal*-type "enhanced duty," requiring that any disparate treatment of competing bidders be "reasonable in relation to the advantage sought to be achieved, or conversely, to the threat which a particular bid allegedly poses to stockholder interests."<sup>14</sup> This substantive judicial review was referred to as "enhanced judicial scrutiny."<sup>15</sup>

Most recently, in its *Paramount Communications Inc. v. QVC Network Inc.* decision,<sup>16</sup> the Delaware Supreme Court again forcefully invoked the "enhanced scrutiny" concept. In *QVC*, the court brought the *Unocal* and *Revlon* analyses under one tent. *QVC* unabashedly states that "rare situations" exist in which the non-interference mode represented by the normal business judgment rule is displaced by "enhanced scrutiny" in which a court tests the directors' conduct "to ensure that it is reasonable."<sup>17</sup> The supreme court succinctly identified two of the circumstances in which enhanced scrutiny would be applied: "(1) the approval of a transaction resulting in a sale of control, and (2) the adoption of defensive measures in response to a threat to corporate control."<sup>18</sup>

The judicial creation and utilization of "enhanced scrutiny" exemplifies a judicial response to a difficult question of corporate governance. The insufficiency of traditional business judgment rule analysis became clear in the highly public and complex takeover fights of the 1980s. The traditional mode of analysis provided little means with which courts could protect stockholder interests. The courts, therefore, came to believe that certain situations required a greater degree of judicial interventionism. "Enhanced scrutiny" provided a rubric for a measured judicial role — one that balanced traditional concepts of deference and institutional restraint with a need to draw some lines and declare some tactics out of bounds.

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<sup>11</sup>506 A.2d 173 (Del. 1986).

<sup>12</sup>559 A.2d 1261 (Del. 1988).

<sup>13</sup>*Id.* at 1287.

<sup>14</sup>*Id.* at 1288.

<sup>15</sup>*Id.*

<sup>16</sup>637 A.2d 34 (Del. 1994).

<sup>17</sup>*Id.* at 42.

<sup>18</sup>*Id.*

Recent developments suggest that "enhanced scrutiny" may be extended beyond the corporate control area to include the core issues of corporate performance. A tougher judicial role in corporate control cases arose from a view that, in the corporate crises that are takeover attempts, the board of directors must be front and center.<sup>19</sup> The courts have continued to admonish that directors are expected "to take an active and direct role in the context of a sale of a company from beginning to end."<sup>20</sup>

A similar conception of the role directors should play in corporate performance has been gaining ground. In a 1992 speech, Chancellor William T. Allen explained:

Outside directors should function as active monitors of corporate management, not just in crisis, but continually; they should have an active role in the formulation of the long-term strategic, financial, and organizational goals of the corporation and should approve plans to achieve those goals; they should as well engage in the periodic review of short and long-term performance according to plan and be prepared to press for correction when in their judgment there is need.<sup>21</sup>

Relatedly, Chancellor Allen has interpreted the post-*Van Gorkom* case law in Delaware as reflecting the courts' demand for "some level of active involvement by directors in the governance of the enterprise."<sup>22</sup> In that vein, the chancellor has urged that outside directors "understand and assume the burden of active long-term monitoring."<sup>23</sup>

Much the same theme was recently sounded by Chief Justice E. Norman Veasey, of the Delaware Supreme Court. In a recent address, Chief Justice

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<sup>19</sup>Before there could be a *Unocal*, there had to be — and was — a *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985), making clear that in the corporate sale context directors were expected to be much more than management rubber stamps. According to *Van Gorkom*, directors may not abdicate to shareholders the directors' responsibility to be active and informed participants in the sale of the enterprise. *Id.* at 873.

<sup>20</sup>*Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 368 (Del. 1993), *modified in part*, 636 A.2d 956 (1994).

<sup>21</sup>Martin Lipton & Jay W. Lorsch, *A Modest Proposal for Improved Corporate Governance*, 48 BUS. LAW. 59, 62 (1992) (quoting Chancellor William T. Allen, Delaware Court of Chancery, *Redefining the Role of Outside Directors in an Age of Global Competition*, Address at Ray Garrett Jr., Corporate and Securities Law Institute, Northwestern University, Chicago (Apr. 1992)).

<sup>22</sup>William T. Allen, *The Evolving Role of Corporate Boards*, Address at the Harvard University Graduate School of Business Administration, Leadership Workshop: *Making Corporate Boards More Effective* 10 (June 24, 1994) (on file with *The Delaware Journal of Corporate Law*).

<sup>23</sup>*Id.* at 12.

Veasey reviewed the significance of independence in the legal rules applicable to the actions of directors and applauded "the establishment of procedures and protocols to ensure that seemingly independent directors are not unwittingly and uncritically following a biased management."<sup>24</sup>

Olena Berg, Assistant Secretary for the Pension and Welfare Benefits Administration of the Department of Labor, also advocated a greater director role in and responsibility for corporate performance:

Clearly, when a [pension] fund takes a significant, long term stake in a company, it has a responsibility as an owner to ensure that management is operating the company in its interests. A pension fund must do more than vote against management entrenchment measures or withhold votes from management. Although this may get management's attention, it is not very productive for the fund's long term investment goals. What is needed are ways of devising a constructive dialogue with management and, most importantly, of assuring active, independent boards of directors who audit and review not only short term corporate financial performance, but all those factors which indicate how the corporation will perform over the long run.<sup>25</sup>

The view that directors should be more responsible for performance — the necessary predicate for the development of more intrusive legal rules applicable to their conduct in this sphere — has thus entered the mainstream. It is no longer the exclusive mantra of stockholder activists. Some additional, notable examples:

- The 1993 Cadbury Report, in *The Code of Best Practice*, advocated that non-management directors should bring their independent judgment to bear on issues of strategy and performance, with a

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<sup>24</sup>E. Norman Veasey, Chief Justice of the State of Delaware, Independence, Address at the 14th Annual Institute of Acquisitions and Takeovers, New York City 7 (June 6, 1994) (on file with *The Delaware Journal of Corporate Law*). In particular, the Chief Justice referred to the "GM Board Guidelines on Significant Corporate Governance Issues." *Id.* at 9. These guidelines are a series of corporate governance rules which emphasize the role of independent outside directors and the flow of business information to the board, and specifically call for an annual, formal evaluation of the chief executive officer by outside directors, based on "performance of the business," "accomplishment of long-term strategic objectives," and "development of management." General Motors Corp., GM Board Guidelines on Significant Corporate Governance Issues 6 (on file with *The Delaware Journal of Corporate Law*).

<sup>25</sup>Olena Berg, Address at the AFL-CIO Asset Managers Conference 10 (Sept. 2, 1993) (on file with *The Delaware Journal of Corporate Law*).

majority being independent of management and with their directors' fees reflecting the time they commit to the company.<sup>26</sup>

- Richard Breeden, former chairman of the Securities and Exchange Commission, commented in a 1992 address that "[t]he board has the access to information and the power to provide meaningful oversight of management's performance." Furthermore, Chairman Breeden suggested that the board needs to use its power "cooperatively but firmly." He emphasized this responsibility especially "when a company is in a downward spiral, since the cost of waiting for a takeover or bankruptcy to make management changes will be far higher than through board action."<sup>27</sup>
- The Business Roundtable's 1990 Statement on Corporate Governance and American Competitiveness identifies the "principal responsibility" of boards of directors as the "exercise [of] governance so as to ensure the long-term successful performance of their corporation." The Roundtable warns that "when results fall behind . . . [a]lternatives must be considered carefully and appropriate action must be taken" to help the company face its most difficult challenges.<sup>28</sup>
- The new (1994) edition of the ABA's *Corporate Director's Handbook* defines the directors' oversight responsibilities to include "approving fundamental operating, financial, and other corporate plans, strategies, and objectives" as well as "evaluating the performance of the corporation and its senior management and taking appropriate action, including removal, when warranted."<sup>29</sup> To that end, the *Handbook* calls for directors' familiarity with the corporation's "principal operational and financial objectives, strategies, and plans" and the "relative standing of its business segments . . . vis-à-vis competitors."<sup>30</sup> Additionally, the *Handbook*

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<sup>26</sup>Report of the Committee of the Financial Aspects of Corporate Governance, *The Code of Best Practice* (Dec. 1, 1992), reprinted in *The Cadbury Report and United Kingdom Corporate Governance*, 11 COMPANY & SEC. L.J. 194 (L.H. Leigh ed., 1993).

<sup>27</sup>Lipton & Lorsch, *supra* note 21, at 62-63 (quoting Richard C. Breeden, Corporate Governance and Compensation, Address at Town Hall of California, Los Angeles, California (June 1992)).

<sup>28</sup>THE BUSINESS ROUNDTABLE, CORPORATE GOVERNANCE AND AMERICAN COMPETITIVENESS, reprinted in 46 BUS. LAW. 241, 246-47 (1990).

<sup>29</sup>SECTION OF BUSINESS LAW, AMERICAN BAR ASSOCIATION CORPORATE DIRECTOR'S HANDBOOK, reprinted in 49 BUS. LAW. 1243, 1249 (1944).

<sup>30</sup>*Id.* at 1250.

suggests that directors ensure that they receive periodic, timely reports on "current business and financial performance, the degree of achievement of approved objectives, and the need to address forward-planning issues."<sup>31</sup>

- The May 1994 Draft Report by the Toronto Stock Exchange Committee on Corporate Governance in Canada, entitled "Where Were the Directors?" identifies as specific board responsibilities the adoption of a corporate strategy and monitoring of senior management.<sup>32</sup> The "explicit assumption by the board of these responsibilities" is stated to be the "first guideline to sound corporate governance."<sup>33</sup>
- John G. Smale, chairman of the Board of General Motors, has posited that the proper role of the board of directors is "to act as an independent auditor of management's progress, asking the tough questions that management might not ask itself — particularly when the company is doing well and is a recognized industry leader."<sup>34</sup>
- A 1993 study by The Conference Board reports that strategy formulation is the area of corporate activity that the board most influences.<sup>35</sup>
- Another recent paper from The Conference Board, "Performance is the Name of the Game," referenced a major study to produce a process for evaluating non-traditional measures of corporate performance based on the proposition that "[o]versight and monitoring of corporations is the role of boards of directors."<sup>36</sup>

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<sup>31</sup>*Id.*

<sup>32</sup>THE TORONTO STOCK EXCHANGE COMMITTEE ON CORPORATE GOVERNANCE IN CANADA, "WHERE WERE THE DIRECTORS?" — GUIDELINES FOR IMPROVED CORPORATE GOVERNANCE IN CANADA 17 (May 1994).

<sup>33</sup>*Id.*

<sup>34</sup>John G. Smale, Address at the Commonwealth and Commercial Clubs of Cincinnati, Ohio 7 (Oct. 21, 1993) (on file with *The Delaware Journal of Corporate Law*).

<sup>35</sup>THE CONFERENCE BOARD, CORPORATE BOARDS AND CORPORATE GOVERNANCE (1993).

<sup>36</sup>Dr. Carolyn Kay Brancato, Research Director, Corporate Governance, The Conference Board, *Getting Past the Bells and Whistles: Evolving Relationships Between Institutional Investors and Corporations*, Address presented at the American Bar Association National Institute: The New Dynamics of Corporate Governance: Guidance for the 1990s, at 17 (Dec. 2-3, 1993) (on file with *The Delaware Journal of Corporate Law*).

- The Department of Labor's July 1994 interpretive bulletin on the responsibilities of pension plan fiduciaries allows activism by plan fiduciaries when shareholder value issues are implicated. The bulletin declared that "in certain situations it may be appropriate for a fiduciary to engage in activities intended to monitor or influence corporate management if the fiduciary expects that such activities are likely to enhance the value of the plan's investment."<sup>37</sup> One of the areas for appropriate activity identified in the release is "assuring that the board has sufficient information to monitor management."<sup>38</sup>
- New SEC disclosure rules, relating to executive compensation, will also facilitate greater focus on director responsibility for corporate performance.<sup>39</sup> These rules require that companies include in their annual proxy statement a graph charting shareholder returns for the company over a specified five-year period against a broad market index (e.g., the S&P 500) and an industry or peer group index. This new disclosure regime will tend to highlight instances of poor performance and help investors to identify whether these poor results reflect embedded industry problems or an underperforming enterprise. The graphic portrayal of that information also will focus greater attention on directors' failures to take action in cases of chronic underperformance.

Taken together, these developments provide the necessary backdrop for increased judicial scrutiny of the directors' responsibilities concerning corporate performance. All of the necessary ingredients for expanding "enhanced scrutiny" beyond the conflict or crisis contexts are present or are developing. Therefore, courts may become less willing to excuse director inaction as directors are perceived to have greater responsibility for corporate performance.

It may be too early to know what form of "enhanced scrutiny" will be created to deal with directors' failure to respond to underperformance. The law may develop to the point where directors are required to conduct or oversee "business audits," either at regular intervals or in response to performance falling below plan or peers.<sup>40</sup> Alternatively, courts may require corporate directors to point to specific procedures or actions taken that

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<sup>37</sup>DEPARTMENT OF LABOR, PENSION, AND WELFARE BENEFITS ADMIN., Interpretive Bulletin 94-2 (July 28, 1994).

<sup>38</sup>*Id.*

<sup>39</sup>See 17 C.F.R. § 229.402(k) (1994).

<sup>40</sup>See Peter F. Drucker, *Reckoning with the Pension Fund Revolution*, HARV. BUS. REV. 316 (Mar./Apr. 1991); Martin Lipton & Steven A. Rosenblum, *A New System of Corporate Governance: The Quinquennial Election of Directors*, 58 U. CHI. L. REV. 187, 245 (1991).

address their responsibility for monitoring and managing corporate performance to establish their "independence."<sup>41</sup>

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<sup>41</sup>*Cf.* Kahn v. Lynch Communication Sys., Inc., 638 A.2d 1110, 1117 (Del. 1994) (applying "careful judicial scrutiny" to a committee of independent directors charged with negotiation of an interested (controlling parent) cash-out merger, in determining whether to shift the burden on "entire fairness" from the transaction's proponents to its opponents).

