ENHANCING THE EFFICIENCY OF BOARD DECISION MAKING: LESSONS LEARNED FROM THE FINANCIAL CRISIS OF 2008

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ABSTRACT

As a result of the financial crisis of 2008, the employment compensation policies and decisions of Wall Street corporate boards have come under close scrutiny. Specifically, the willingness to approve company-wide compensation plans that resulted in the paying out of billions of dollars in bonuses, even in the face of deteriorating financial and economic conditions, has been a highlight of the controversy. If only these firms had retained the bulk of these large annual bonuses over the last several years when the financial markets were noticeably in decline, perhaps the economic impact of the current financial crisis would have been less severe.

It is now understood that board approval of compensation policies that are heavily weighted toward large bonuses can encourage the pursuit of fake alpha and that the decisions to pay out huge amounts of company capital in the form of bonuses may primarily be the result of fake alpha being successfully achieved. In terms of corporate governance, these decisions reveal how opportunistic rent seeking stakeholders can pressure the corporate board into excessively risky decisions that can jeopardize the financial health of the corporation. The question then becomes whether corporate law needs to be modified to deal with this weakness in corporate governance and if so, how should it be done. In this article, it is argued that courts should require a public company's board—a board composed of a majority of presumably independent and disinterested members—to fulfill an enhanced duty in the process of deciding to approve policies or making decisions that on their face implicate both opportunistic rent seeking behavior on the part of one or more company stakeholders and the financial health of the firm. Such board decisions would necessarily include, among

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others, those decisions that involve moving massive amounts of cash out of the company and into the pockets of one or more stakeholders (huge company-wide bonuses, large executive management team compensation, large dividend payouts, aggressive stock buybacks, etc.).

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I. INTRODUCTION

Under corporate law, the board of directors is the ultimate decision making authority[1] in a public company.[2] This point is often ignored because so many board decisions are correctly delegated to executive officers and those other officers and managers in the chain of command that possess the expertise and informational advantages to make superior decisions on behalf of the organization.[3]

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

While the approval of the Ovitz employment agreement was a very significant compensation decision for the Disney board, that decision paled

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

[2]A publicly held firm (public company) is an economic organization "in which (i) management and residual claimant status (shareholding) are separable and separated functions; (ii) the residual claims (shares) are held by a number of persons; and (iii) the residual claims are freely transferable and neither entry to nor exit from the firm is restricted." Michael P. Dooley, *Two Models of Corporate Governance*, 47 BUS. LAW. 461, 463 n.9 (1992).

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

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

[5]Eisenberg, *supra* note 3, at 239 (stating that even if the board is primarily involved in monitoring, "the board also has important decision making functions").

[6]*In re* Walt Disney Co. Deriv. Litig., 906 A.2d 27 (Del. 2006).

[7]*Id.* at 57.

in comparison to the compensation decisions made by Wall Street's largest public companies before and during the financial crisis of 2008. Those decisions involved the approval of company-wide compensation plans that resulted in paying billions of dollars in bonuses to thousands of *non-executive management employees* even in the face of deteriorating financial and economic conditions. These decisions resulted in employees at the top five Wall Street firms, Goldman Sachs, Merrill Lynch, Morgan Stanley, Lehman Brothers, and Bear Stearns, being paid a record $39 billion in bonuses in 2007,[8] up from $36 billion in 2006.[9] Moreover and somewhat remarkably, in 2008—the year in which Lehman Brothers went bankrupt, Merrill Lynch and Bear Stearns had to find merger partners because of extreme financial difficulty, Wall Street firms combined to lose tens of billions of dollars, and billions of taxpayer dollars went to bail out Wall Street firms—the New York Comptroller reported that Wall Street firms still paid out at least $18.4 billion in employee bonuses.[10] Most blatant was Merrill Lynch's decision to release $3.6 billion in board-approved bonuses to a large number of employees on December 29, 2008, just prior to the closing of its merger with Bank of America and shortly after it was known that Bank of America was requesting an extra $20 billion in bailout funds from the federal government in response to huge losses at Merrill Lynch.[11] If only these and other Wall Street firms had retained the bulk of these large annual bonuses over the last several years when the mortgage markets were noticeably in decline, perhaps the economic impact of the current financial crisis would have been less severe.

At first glance, it is hard to understand what the corporate boards of Wall Street firms were thinking when they approved company-wide compensation policies that were so heavily weighted to the annual bonus.

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[8] *See* Tom Randall & Jamie McGee, *Wall Street Executives Made $3 Billion Before Crisis (Update1)*, BLOOMBERG.COM, Sept. 26, 2008, http://www.bloomberg.com/apps/news?pid=20601109&sid=aGL5l6xOPEHc&refer=exclusive (reporting that $39 billion in bonuses were paid to employees at the five biggest Wall Street firms in 2007).

[9] Christine Harper, *Wall Street Bonuses Hit Record $39 Billion for 2007 (Update3)*, BLOOMBERG.COM, Jan. 17, 2008, http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aHPBhz66H9eo.

[10] *See* Ben White, *What Red Ink? Wall Street Paid Hefty Bonuses*, N.Y. TIMES, Jan. 29, 2009, at A1; *see also* Heather Landy, *Wall Street Bonuses Draw Scrutiny in Bailout's Wake*, WASH. POST, Jan. 24, 2009, at D1 (reporting that billions of dollars were paid in bonuses to employees in 2008).

[11] *See* Greg Farrell, *Lynched at Merrill*, FIN. TIMES (London), Jan. 26, 2009, at 7; *see also* Karen Freifeld, *Merrill Bonus Recipients May Be Named Within a Week (Update4)*, BLOOMBERG.COM, Mar. 13, 2009, http://www.bloomberg.com/apps/news?pid=newsarchive&sid=agTUhFD7vAMg (stating that 696 employees got bonuses of $1 million or more).

By doing so, they created a powerful class of residual claimants that rivaled the position of shareholders, and thereby moved their companies far away from a model of corporate governance that is commonly referred to as shareholder primacy.[12] Nevertheless, as discussed in detail below, these compensation policy decisions can be explained as being quite rational for multiple reasons, especially when put into the context of a team production approach to corporate law.[13]

However, while rational from the perspective of a corporate board, these decisions may have been sub-optimal for the corporation if executives, traders and investment bankers had been engaged in "opportunistic rent seeking behavior."[14] Rent seeking

> refers to situations where individuals expend time, money, and other resources competing for a fixed amount of wealth, in effect squabbling with each other over the size of their individual pieces of a fixed group pie. Because rent seeking itself is costly, the net result is to reduce total wealth available for distribution.[15]

In terms of this article, opportunistic rent seeking behavior refers to *rent seeking by certain stakeholders*[16] *at times of artificial strength in negotiating position relative to other stakeholders*. Artificial strength is a critical element of the definition for it implies that a board's decision making in response to such behavior may be based upon misinformation or the result of weaknesses in the dynamics of small group decision making as described below. Moreover, it is not required that this position of artificial strength be obtained through deception, only that it exists and is being used for purposes of rent seeking.

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[12]Shareholder primacy takes the "perspective that . . . directors of public corporations ought to be accountable only to the shareholders, and ought to be accountable only for maximizing the value of the shareholders' shares." Margaret M. Blair & Lynn A. Stout, *Director Accountability and the Mediating Role of the Corporate Board*, 79 WASH. U. L.Q. 403, 404 (2001).

[13]*See* Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 249-50 (1999) (seminal work on team production and corporate law).

[14]*Id.* at 249.

[15]*Id.* at 249 n.4.

[16]Stakeholders are defined as the individuals and constituencies that contribute, either voluntarily or involuntarily, to its wealth-creating capacity and activities, and that are therefore its potential beneficiaries and or risk bearers. *See* Joseph T. Mahoney, Towards a Stakeholder Theory of Strategic Management 3 n.1 (2009) (unpublished manuscript), *available at* http://uk.cbs.dk/content/download/47821/689783/file/Towards%20a%20Stakeholder%20Theory%20of%20the%20Firm%20in%20Strategic%20 Management.pdf.

In terms of Wall Street firms, the alleged rent seeking behavior by executives, traders, and investment bankers is believed to have occurred because compensation policies based on large annual bonuses encouraged these employees to pursue what Professor Raghuram Rajan of the University of Chicago Business School refers to as "fake alpha" (appearing to create excess returns but in fact taking on hidden tail risks, which produce a steady positive return most of the time as compensation for a rare, very negative, return).[17] This rare, very negative return results from what can be referred to as a "disaster." An example is the financial chaos created by the recent sharp collapse in U.S. housing prices, a collapse that was preceded by approximately fifty years of almost uninterrupted annual housing price increases. But for pursuers of fake alpha, a disaster is not a major concern if the probability of it occurring is very low. Where the probability of a disaster is low, these "events occur rarely, and if they occur at all it is unlikely to be in the immediate future."[18] In essence, the pursuers of fake alpha trade tail risk for cash, and hope that things do not blow up until after huge bonuses have been paid out for a number of years.[19]

By investing in fake alpha, Wall Street firms are not earning excess returns above what the market will offer for the risk taken (real alpha), only normal returns with an unusual risk-return profile.[20] The result is a misleading appearance of profitability that leads to an under-capitalized institution if compensation policies are not adjusted accordingly.[21] Unadjusted compensation polices treat the annual returns earned for pursuing fake alpha as low risk when compensating executives, investment bankers, and traders, while the risks of loss are shifted to those who hold other interests in the company (such as shareholders and ordinary employees, and now the U.S. taxpayers) even though the costs of risk-taking may not be felt by these stakeholders for a number of years.[22] Unfortunately, pay-up time has now arrived and it is clear that the large bonuses given out in 2006, 2007, and 2008, if not also in prior years, were not warranted and contributed significantly to the ongoing financial crisis.[23]

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[17]Raghuram Rajan, *Bankers' Pay is Deeply Flawed*, FIN. TIMES (London), Jan. 9, 2008, at 15.

[18]RICHARD POSNER, A FAILURE OF CAPITALISM: THE CRISIS OF '08 AND THE DESCENT INTO DEPRESSION 27 (2009).

[19]Bernard S. Sharfman et al., *Wall Street's Corporate Governance Crisis*, 17 CORP. GOVERNANCE ADVISOR 5 (2009).

[20]*Id.*

[21]*Id.*

[22]*Id.* at 5-6.

[23]Sharfman et al., *supra* note 19, at 6.

Perhaps the fall of American International Group, Inc. (AIG) serves as a classic example of how this can occur. As the story goes, AIG's Finan-cial Products unit had initially figured out a way to make real alpha by providing credit default swaps (an agreement between two parties pursuant to which the seller promises the buyer a payment in the event a bond or a loan defaults) on corporate bonds.[24] But the unit could not stop at generating real alpha for a relatively small book of business; it ultimately began providing credit default swaps on more volatile forms of debt such as mortgage backed securities.[25] This new business ultimately led to the firm's demise.

But before the tail risk involved in the unit's business was exposed, the unit produced outstanding results and its employees were rewarded handsomely. The unit's revenue rose from $737 million in 1999 to $3.26 billion in 2005.[26] Its operating income rose from 4.2% of AIG's overall operating income in 1999 to 17.5% in 2005.[27] During this time, the approximately 400 employees of this small unit were provided compensation ranging from $423 million to $616 million each year, making the average annual compensation of each employee of the unit more than $1 million.[28]

What appears to have occurred at AIG is a classic example of some traders pursuing fake alpha through schemes which are referred to as "Lo strategies."[29] These strategies boil down to generating fake alpha by writing "deeply out-of-the money options at the start of the reporting period and hope that they do not end up in the money by the end of the period."[30] In essence, an insurance policy is sold insuring the losses resulting from a potentially disastrous event, but with a small chance of the event triggering payoff actually occurring. Revenue is booked, enhancing the reported returns,[31] but without sufficient recognition of the potential losses that could occur if the disastrous event actually materializes. Of course, as we all know, it did.

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[24] *See* Brady Dennis & Robert O'Harrow Jr., *A Crack in the System*, WASH. POST, Dec. 30, 2008, at A1.

[25] *Id.*

[26] Gretchen Morgenson, *Behind Biggest Insurer's Crisis, A Blind Eye to a Web of Risk*, N.Y. TIMES, Sept. 28, 2008, at A1.

[27] *Id.*

[28] *Id.*

[29] *See id.* Lo strategies were named after Professor Andrew Lo, who was the first to provide a specific example of such a strategy. Dean P. Foster & H. Peyton Young, *The Hedge Fund Game: Incentives, Excess Returns, and Performance Mimics* 4 (Wharton Fin. Insts. Ctr., Working Paper No. 07-42, 2008), *available at* http://fic.wharton.upenn.edu/fic/papers/07/p0742.htm.

[30] Foster & Young, *supra* note 29, at 6.

[31] *Id.*

To be fair, it is quite possible that some or most executives, traders, and investment bankers who pursued fake alpha at Wall Street firms did so without the intent to deceive. If so, they thought they were actually pursuing real alpha, but in reality were just pursuing fake alpha with no real expectation of excess returns.[32]

As a result of the financial crisis of 2008, it is now understood that board approval of compensation policies that are heavily weighted toward large bonuses can encourage the pursuit of fake alpha. It is likely that the decisions to pay out huge amounts of company capital in the form of bonuses may primarily be the result of fake alpha being successfully achieved.

Based on the lessons learned from the financial crisis of 2008, this article argues that corporate law should require a public company's board—a board composed of a majority of presumably independent[33] and disinterested members—to fulfill an enhanced duty in the process of approving policies or making decisions that on their face implicate both opportunistic rent seeking behavior by one or more company stakeholders and the financial health of the firm. By doing so, it is expected that the efficiency of board decision making will be enhanced.

Such board decisions would necessarily include those decisions that involve moving massive amounts of cash out of the company and into the pockets of one or more stakeholders (huge company-wide bonuses, large executive management team compensation, large dividend payouts, aggressive stock buybacks, etc.). However, such decisions are not the only type of board decisions that on their face implicate both opportunistic rent seeking behavior and the financial health of the firm. Another example is the Enron board that gave its approval for executive management to establish and operate the now infamous LJM private equity funds, even though executive management had clear conflicts of interest in these transactions.[34] Or, when executive management recommends that the company enters into one or more major acquisitions that may result in changing its business and/or

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[32] *Id.* at 7.

[33] For a public company to be listed on a major stock exchange, a majority of its board members must meet minimum exchange requirements for independence. For example, the New York Stock Exchange requires a public company's board to have a majority of independent directors and that the major corporate board committees—audit, compensation, and nominating—be composed entirely of independent members. *See* NYSE, Inc., Listed Company Manual §§ 303A.02–303A.07 (2009).

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

financial risk profile. These types of decisions should also require an enhanced duty.

The issue presented is analyzed utilizing the same value of centralized authority framework that this author presented in a prior article, *The Enduring Legacy of* Smith v. Van Gorkom.[35] Such a framework of analysis understands that "the real value of the corporate form is its hierarchical nature as reflected in the centralized authority of the corporate board."[36] This authority provides unique organizational efficiencies to a public company.[37] These efficiencies are "manifested by the corporate board's ability to (1) efficiently filter information in its decision-making process and (2) act as a mediating hierarchy. Such organizational efficiencies create a strong presumption that the laws of corporate governance should not interfere with the corporate board's decision-making process."[38]

Even within this framework, however, this article proposes that an enhanced duty be applied to board decisions which on their face implicate both opportunistic rent seeking behavior by one or more corporate stakeholders such as executive management, employees, or shareholders and the financial health of the firm. As discussed below, this enhanced duty has its own unique standard of conduct and review.

The analytical approach taken in this article is meant for general application in all jurisdictions that have their own corporations law or the equivalent, both domestically and internationally. Nevertheless, the discussion that follows has been pragmatically framed in the context of Delaware corporate law. Delaware is the state where the majority of the largest U.S. companies are incorporated,[39] and its corporate law often serves as the authority that other U.S. states look to when developing their own statutory and case law.[40] Therefore, the examples are from Delaware, but the thinking is meant to be global in nature.

Part II of the article describes how a team production understanding of corporate law provides a rational explanation for the making of Wall Street

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[35]Bernard S. Sharfman, *The Enduring Legacy of* Smith v. Van Gorkom, 33 DEL. J. CORP. L. 287, 290-91 (2008).

[36]*Id.* at 290.

[37]*Id.*

[38]*Id.* at 290-91; *see infra* text accompanying notes 118-25.

[39]*See* LEWIS S. BLACK, JR., WHY CORPORATIONS CHOOSE DELAWARE 1 (2007), *available at* http://corp.delaware.gov/whydelaware/whycorporations_web.pdf. According to the State of Delaware web site, Delaware is the legal home to more than 50% of all U.S. publicly-traded companies and 60% of the Fortune 500. *See* Delaware Division of Corporations, http://corp.delaware.gov (last visited Sept. 1, 2009).

[40]Nadelle Grossman, *Director Compliance with Elusive Fiduciary Duties in a Climate of Corporate Governance Reform*, 12 FORDHAM J. CORP. & FIN. L. 393, 397 (2007).

compensation decisions. Part III identifies types of decisions that on their face implicate both opportunistic rent seeking behavior and the financial health of the firm. Part IV discusses the value of centralized authority. Part V discusses the value of accountability. Part VI describes the new enhanced duty and a standard of review for decisions that on their face implicate opportunistic rent seeking behavior. Finally, Part VII concludes with a general overview.

II. RATIONALITY, TEAM PRODUCTION, AND CORPORATE WASTE

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

> [The BJR] is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company. Absent an abuse of discretion, that judgment will be respected by the courts. The burden is on the party challenging the decision to establish facts rebutting the presumption.[41]

The BJR protects a corporate board decision from judicial review if four conditions are met.[42] First, the board must make a decision.[43] A decision not to act meets this requirement.[44] Second, the board must have engaged in a process to become adequately informed of all material information reasonably available to make its decision.[45] Third, the board must have made its decision in good faith.[46] Fourth, the decision must have been made by disinterested directors of the board.[47]

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[41] Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) (citations omitted).

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

[43] *Id.*

[44] *Id.*

[45] *Id.*

[46] Eisenberg, *supra* note 42, at 441.

[47] *Id.*

But even if the decision is protected by the BJR, it must not result in corporate waste. According to the Delaware Supreme Court in the much publicized *Disney* litigation:[48]

> To recover on a claim of corporate waste, the plaintiffs must shoulder the burden of proving that the exchange was "so one sided that no business person of ordinary, sound judgment could conclude that the corporation has received adequate consideration." A claim of waste will arise only in the rare, "unconscionable case where directors irrationally squander or give away corporate assets." This onerous standard for waste is a corollary of the proposition that where business judgment presumptions are applicable, the board's decision will be upheld unless it cannot be "attributed to any rational business purpose."[49]

It could be argued that the recent decisions of Wall Street boards to pay out billions of dollars in compensation to executives, traders, and investment bankers, during a time when their respective firms were reporting reduced profitability and facing a deteriorating economic and financial environment, were irrational, resulting in corporate waste. As such, they cannot be protected by the BJR. However, there are multiple defenses to this accusation. First, Wall Street boards can argue that they did not understand that fake alpha was being pursued by their respective companies' employees, meaning that they simply overvalued the benefit provided by these employees. Second, the market demanded a high price to be paid for these critical inputs and therefore there was nothing the boards could do to reduce the cost and still remain competitive. Finally, and most critically, a team production approach to corporate law, an approach that explains the relationship between the board and company stakeholders, would argue that the decisions of Wall Street firms were rational because they were made with a very important business purpose in mind, keeping the team together.

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[48] *In re* Walt Disney Co. Deriv. Litig., 906 A.2d 27 (Del. 2006). In *Disney*, the Delaware Supreme Court applied this standard when it rejected plaintiffs' arguments that the board committed corporate waste when it approved the contractually agreed to non-fault termination (NFT) payment to Michael Ovitz (president of Disney) upon his termination. *Id.* at 74-75.

[49] *Id.* (footnotes omitted).

A. *Understanding the Relationship Between the Board and Company Stakeholders: A Team Production Approach to Corporate Law*

In their seminal work on team production and corporate law, *A Team Production Theory of Corporate Law*,[50] Professors Margaret Blair and Lynn Stout argue that a public company needs to be understood as a team of members who make firm-specific investments in the corporation with the goal of producing goods and services as a team (team production),[51] with the board of directors serving as a "mediating hierarchy."[52] From this perspective, the interests in a public company are represented by a "joint welfare function of *all* the individuals who make firm-specific investments and agree to participate in the extracontractual, internal mediation process within the firm."[53]

Team members are primarily made up of executives, rank-and-file employees, and equity investors, but can also include researchers, creditors, the local community, marketers, and vendors who provide specialized products and services to the firm and shareholders, among others.[54] Any person or entity that makes a firm-specific investment, but is "unable to protect [that] investment[] by direct contracting, personal trust, or

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[50]Blair & Stout, *supra* note 13, at 271-76.

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

[52]Blair & Stout, *supra* note 13, at 271-76. This seminal work was heavily influenced by the insights developed by Professors Raghuram Rajan and Luigi Zingales on how various stakeholders make firm-specific investments in the firm. *See* Raghuram G. Rajan & Luigi Zingales, *Power in the Theory of a Firm*, 113 Q.J. ECON. 387 (1998). Significantly, Professors Blair and Stout noted that the mediating hierarchy model of the firm does not work well where the firm is subject to the control of one shareholder or a group of shareholders. Under those conditions, the lack of independence impedes the ability of directors to act as mediating hierarchs. Blair & Stout, *supra* note 13, at 309. This distinction is consistent with the recent work of Lucian A. Bebchuk and Assaf Hamdani in which they argue that best corporate governance practices must differ between public companies that have controlling shareholders and those that do not. *See* Lucian A. Bebchuk & Assaf Hamdani, *The Elusive Quest for Global Governance Standards*, 157 U. PA. L. REV. 1263 (2009). Nevertheless, from this author's perspective, it is not clear why the board cannot function as an effective mediating hierarchy in the presence of a controlling shareholder assuming that the board has a good track record of fulfilling the implicit contracts made with the company's stakeholders.

[53]Blair & Stout, *supra* note 13, at 288.

[54]*Id.* at 276 & n.61.

reputation," is a member of the team.[55] The result is "that no one team member is a 'principal' who enjoys a right of control over the team."[56]

In team production, it is recognized that agency costs may be created by the tendency of team members to (1) shirk their duties, that is, "fail to make optimum efforts to ensure a joint project's success, instead free-riding on others' efforts,"[57] and (2) opportunistically seek rents at the expense of other team members.[58] Such agency costs can destroy the ability of the team to stay together and, because of the complexity of team production, cannot be remedied by explicit contracting between team members.[59]

Professors Blair and Stout see corporate law as a solution, if only a second best solution,[60] to the agency costs caused by team production. In this stakeholder approach to understanding the public company,[61] the board of directors, composed primarily of outside members who are also independent of the firm, provides a unique mediating function. Not only does it have the final authority on hiring and firing corporate officers, approving corporate policy, recommending major transactions for shareholder approval, approving executive compensation packages, and more, but it also acts "as an internal 'court of appeals' to resolve disputes that may arise

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[55]Lynn M. LoPucki, *A Team Production Theory of Bankruptcy Reorganization*, 57 VAND. L. REV. 741, 749 (2004). The firm-specific investment made by a trader or investment banker can be thought of as a contribution of his or her unique skills and abilities in exchange for a unique class of non-voting stock. Thinking in terms of options, the employee is provided an in-the-money non-tradable European call option written by the employer, providing the employee with the expectation, but not the guarantee, of a large bonus at the end of the bonus period—a bonus that only the employer who has written the call option can pay. Even though the time horizon is short, the employee is committed to the company until the bonus is paid out. If the employee leaves prior to payout, he forfeits the accrual value of his expected large bonus. This type of compensation arrangement also makes the employee very dependent on the board to be fair in distributing the firm's residual profits on an ex post basis.

[56]Blair & Stout, *supra* note 13, at 277 (emphasis omitted).

[57]*Id.* at 249 n.3.

[58]*Id.* at 249 n.4.

[59]*Id.* at 249-50.

[60]That is, "the best outcome that can be achieved, given that some of the conditions necessary for a first-best solution are violated." Blair & Stout, *supra* note 13, at 250 n.6.

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

among the team members."[62] In this role, board members are "mediating hierarchs whose job is to balance team members' competing interests in a fashion that keeps everyone happy enough that the productive coalition stays together."[63]

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

> Team members choose to trust the board in part because they cannot trust each other. Board members receive salaries and perks, and may own some small amount of stock. But corporate law restricts their right to enrich themselves at the expense of the corporation. Board members cannot usurp corporate opportunities or control decisions in which their own interests conflict with those of the corporation. They are not residual claimants under the team production contract. To put it most bluntly, directors can steal, but directors cannot steal much. Those are the conditions most conducive to the fulfillment of a trust obligation.[64]

As summarized by Professors Blair and Stout, "In essence, the mediating hierarchy solution requires team members to give up important rights (including property rights over the team's joint output and over team inputs such as financial capital and firm-specific human capital) to a legal entity created by the act of incorporation."[65]

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

B. *Support for the Board's Role as a Mediating Hierarchy*

An alternative approach to understanding corporate law is to believe that it is structured to maximize shareholder wealth. This perspective is the mainstream of corporate law. According to Professors Hansmann and Kraakman, "There is no longer any serious competitor to the view that

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[62]Blair & Stout, *supra* note 13, at 276-77.
[63]*Id.* at 281.
[64]LoPucki, *supra* note 55, at 751 (footnotes omitted).
[65]Blair & Stout, *supra* note 13, at 250.

corporate law should principally strive to increase long-term shareholder value."[66] In this worldview of corporate law, directors indirectly sit on top of the corporate pyramid as corporate managers and should have an obligation to manage according to shareholder interests.[67]

This viewpoint has been enhanced by the transition over time to a corporate board that is dominated by independent directors. According to Professor Jeffrey Gordon, over the last half century, there has been a dramatic shift in board focus from managerialism, i.e., the goals of management, to shareholder wealth maximization.[68] Not coincidentally, this shift has occurred during a time when the percentage of independent directors serving on the typical board of a public company has increased from 22% to an astonishing 74%.[69] Professor Gordon attributes this shift in focus to the notion that independent directors, unlike the insiders and interested outsiders who dominated corporate boards in the 1950s, are less committed to management and its vision.[70] Instead, they look to outside performance signals, such as information provided by the stock market, to assess the performance of the firm.[71] Facilitating this focus has been enhanced SEC disclosure requirements and more transparent accounting standards, which allow corporate information that once had been known only to insiders to become reflected in stock prices, which in turn have become much better indicators of company performance.[72] According to Professor Gordon, the overriding effect is to commit the firm to a shareholder wealth maximizing strategy as best measured by stock price performance.[73]

The economic rationale for utilizing a "shareholder primacy norm" is that the firm should be viewed as nexus of contracts where all contractual relationships are explicit except for the firm's contract with shareholders, who are the sole residual claimants to the income of the corporation.[74] Because only shareholders bear risks from discretionary decisions made by the corporation, the firm should be governed to maximize shareholder value.

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[66]Hansmann & Kraakman, *supra* note 61, at 439.

[67]*Id.* at 440-41. According to Professors Easterbrook and Fischel, shareholder primacy can be thought of as the default rule under corporate law because it is the "operational assumption of successful firms." FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 36 (1991).

[68]Jeffrey N. Gordon, *The Rise of Independent Directors in the United States, 1950-2005: Of Shareholder Value and Stock Market Prices*, 59 STAN. L. REV. 1465, 1540 (2007).

[69]*Id.* at 1565 tbl.1.

[70]*Id.* at 1563.

[71]*Id.*

[72]Gordon, *supra* note 68, at 1541.

[73]*Id.* at 1563.

[74]*See* Mahoney, *supra* note 16, at 10.

In this way, the maximization of social welfare is directly linked to the maximization of shareholder value.[75]

But when one relaxes the requirement of explicit contracts, so that implicit contracts are allowed to exist, the picture changes entirely.[76] By doing so, other residual claimants are given life and thus become rivals to the residual claims of shareholders. For example, consider the firm entering into compensation arrangements with employees where there is an implicit understanding that a good faith effort will be made at the end of the year to pay out significant bonuses in addition to relatively small fixed wages. As we have seen, this has been a common compensation arrangement at Wall Street firms, with the result that the boards of these firms must deal with a residual claimant whose interests must be considered at a level that equals or exceeds those of shareholders.

The implications for corporate governance are clear. Stakeholders may make firm-specific investments that are not necessarily protected by explicit contracts.[77] The greater the extent a corporation enters into implicit contracts with its stakeholders, the greater the need for a board to act as a mediating hierarchy. Moreover, where implicit contracts dominate, shareholder primacy is no longer a viable norm to guide board decision making. Conversely, the greater the extent a corporation enters into explicit contracts with its stakeholders, the more the board must incorporate the interests of shareholders into its decisions. Theoretically, a firm may enter into only explicit contracts with its stakeholders, allowing the board to concern itself solely with the interests of shareholders. But in this way, pure shareholder primacy can *only* be considered a special case of corporate governance. If only a special case, then it is hard to justify making shareholder wealth maximization the only norm guiding corporate governance or corporate law.

Furthermore, logic, experience, and our understanding of corporate law tells us that it does not endorse a shareholder primacy norm. If corporate law was based on a shareholder primacy norm, one should at least expect that it would treat shareholders as owners of the corporation. But this is not the case. Although shareholders do own interests in the corporation by owning company stock, they do not have ownership of the corporate entity. Title to corporate assets is in the name of the corporation, not its shareholders.[78] Moreover, and perhaps most importantly, corporate assets are

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[75] *Id.*
[76] *Id.* at 13.
[77] Blair & Stout, *supra* note 13, at 314 n.178.
[78] *Id.* at 269.

controlled by the corporation's board of directors, not its shareholders.[79] Without control, shareholders become merely the "'recipient[s] of the wages of capital.'"[80]

And even while shareholders do have potential claims to the residual profits of the corporation, it is the board of directors that decides if a dividend will be paid, and how much the dividend will be. Corporate law clearly does not require the corporate board to follow the commands of its shareholders.[81] Shareholders may ratify a board's action, but the board must first approve the action.[82] Even if shareholders pass a unanimous resolution requesting the board to act in some specific matter, the board has the legal right to ignore such a resolution.[83]

In addition, "directors are not agents [of shareholders] in a legal sense."[84] Directors do not owe duties of obedience to shareholders.[85] Courts will not necessarily identify to which specific stakeholders directors owe fiduciary duties; they may say simply that the duties are owed to the corporation.[86] Again, this is more consistent with a team production approach to corporate law than a shareholder primacy norm.

Finally, it is clear that the courts that adjudicate corporate law cases do not focus on shareholder wealth as the rationale for their decisions, limiting it to unusual situations such as when *Revlon* duties are to be applied.[87] This is most obvious when courts use the BJR to squash shareholder actions from an alleged breach in directors' duty of care.[88] Moreover, dictum from the Delaware Supreme Court's opinion in *Revlon* makes it clear that the duty of

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

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

[81] *Id.* at 291.

[82] Dooley, *supra* note 2, at 468.

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

[84] *Id.* at 290.

[85] *Id.*

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

[87] Blair & Stout, *supra* note 13, at 406.

[88] *See* Smith, *supra* note 86, at 285-86. As stated by Professor Smith, "Outside the takeover context, however, application of the shareholder primacy norm to publicly traded corporations is muted by the business judgment rule." *Id.* at 279-80.

the board *before* the decision to sell the company is the preservation of the corporation, not shareholder wealth maximization:

> The Revlon board's authorization permitting management to negotiate a merger or buyout with a third party was a recognition that the company was for sale. The duty of the board had thus changed from the preservation of Revlon as a corporate entity to the maximization of the company's value at a sale for the stockholders' benefit.[89]

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

C. *The Interests of Shareholders*

The rationale for why shareholders would accept such an arrangement is that team members, including shareholders, "understand they would be far less likely to elicit the full cooperation and firm-specific investment of other members [for fear of shirking and rent-seeking] if they did not [all agree to] give up control rights" to a mediating hierarchy (the board of directors), which has the responsibility of allocating "duties and rewards."[90] Moreover, the team production theory of corporate law suggests that "a legal rule requiring corporate directors to maximize shareholder wealth ex post might well have the perverse effect of reducing shareholder wealth over time by discouraging non-shareholder groups from making specific investments in corporations ex ante."[91]

In the context of firms where implicit contracts dominate, such as Wall Street firms, shareholders can be understood as contracting away their right to the shareholder wealth maximization norm in both board decision making and the law. They do this because they believe that by giving up their position as the dominant residual claimant they will be economically better off, trusting that the board will adequately fulfill its role as a mediating hierarchy.

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[89]Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 182 (Del. 1986).

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

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

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

Corporate law, by promoting the ability of the corporate board of a public company to act as a mediating hierarchy, encourages the firm-specific investment of team members, making incorporation a desirable means for establishing the rights and remedies of a public company's team members. However, the ability to act as a mediating hierarchy is not a perfect solution to the agency costs associated with team production. As an institutional substitute for the use of explicit contracts, it is still a second best solution.[92] This is most evident when the board is dealing with stakeholders who are negotiating from the position of artificial strength, such as those employees who pursue and obtain fake alpha.

As described in the Introduction, these stakeholders will create a severe challenge for a board in its role as a mediating hierarchy. Executives, traders, and investment bankers who pursue and realize fake alpha will justify getting a larger share of the pie because of their outstanding financial results. If they do not get what they think they deserve in the way of bonuses, they may leave the firm and break up the team. The resulting harm to the firm results from the likelihood that their replacements will be inferior in skill and profit generating potential. This can be assumed because the firm will no doubt gain a reputation for not being able or willing to adequately fulfill its implicit (bonus) contracts.[93] Only those prospective employees with lower bonus expectations and presumably lower productivity would apply for the vacated positions. Therefore, even when faced with a deteriorating economic and financial environment, and with the knowledge that allowing billions of dollars to exit the company coffers may harm the firm's financial health, a Wall Street board may succumb to the pressure and allow for a massive cash outflow in the form of bonuses to avoid mass defections and a breaking up of the team.

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

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[92]Blair & Stout, *supra* note 13, at 250.

[93]Mahoney, *supra* note 16, at 14 (noting how stakeholders may be more willing to make firm-specific investments if the corporation has the reputation for fulfilling it implicit contracts).

III. IDENTIFYING DECISIONS THAT ON THEIR FACE IMPLICATE BOTH OPPORTUNISTIC RENT SEEKING BEHAVIOR AND THE FINANCIAL HEALTH OF THE FIRM

As a mediating hierarchy, the board of a public company is always balancing the interests of its various stakeholders when it makes its decisions. It does so to minimize the desire of the company's stakeholders to participate in rent seeking behavior. That does not mean, however, that certain stakeholders will not opportunistically try and do so. The request to move massive amounts of cash out of the corporation and into the pockets of one or more stakeholders is a virtual red flag that this may be occurring. Moreover, such movement of funds can jeopardize the financial health of the firm. Of course, these decisions may involve large amounts of bonus compensation as we have already discussed. But they also may involve extraordinary dividend payouts or large stock repurchases. On their face, these decisions also implicate both opportunistic behavior on the part of one or more corporate stakeholders and the financial health of the firm and therefore deserve heightened scrutiny by the board.

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

> The mediating hierarchy model consequently suggests that the public corporation can be viewed most usefully not as a nexus of implicit and explicit contracts, but as a nexus of firm-specific investments made by many and varied individuals who give up control over those resources to a decision making process in hopes of sharing in the benefits that can flow from team production.[94]

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

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[94]Blair & Stout, *supra* note 13, at 285 (emphasis omitted).

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

Decisions associated with massive cash outflows to certain stakeholders are not the only type of board decisions that on their face implicate both opportunistic rent seeking behavior and the financial health of the firm. For example, consider the board decisions that helped contribute to the infamous failure of Enron.[95] In 1999 and 2000, the Enron board approved three waivers to the company's code of conduct to allow Enron's chief financial officer (CFO), Andrew Fastow, to establish and operate the now infamous LJM private equity funds.[96] "These funds were set up to acquire Enron assets with the purpose of reducing the size of the Company's balance sheet"[97] and gave Fastow the opportunity to conduct self-dealing transactions to the detriment of Enron and its shareholders.[98] Unfortunately, Fastow did not let the opportunity pass.[99] Ken Lay, Enron's chief executive officer (CEO) at the time the funds were created, knew of the controversial nature of this arrangement, prompting him to seek board ratification despite his authority to approve the waivers on his own.[100]

1. Dysfunctional Deference

The scenario just described, a scenario that clearly implicates opportunistic rent seeking behavior on the part of executive management, "should have led to long and intense board deliberations, yet very little in the way of deliberations were reported prior to board approval, evidencing an incredible and surprising deference to the recommendations of management."[101] Without deliberation, there is no opportunity for board members to share potentially valuable information they may individually have regarding the decision, making the board as a whole less informed.[102] Extreme deference to insiders and executive management leading to a stifling of board deliberations can accurately be referred to as dysfunctional deference.[103]

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[95]Sharfman & Toll, *supra* note 34, at 155-56 (describing the Enron situation).

[96]*Id.* at 155.

[97]*Id.* at 155-56.

[98]*Id.* at 156.

[99]Sharfman & Toll, *supra* note 34, at 156.

[100]*Id.*

[101]*Id.*

[102]*See id.* (arguing that when "board insiders are honest about the pros and cons of a prospective decision asymmetric distribution of information should be beneficial to board decision-making").

[103]*See* Sharfman & Toll, *supra* note 34, at 156 (coining the phrase "dysfunctional deference"

2. Group Polarization

A board succumbing to dysfunctional deference is an extreme example of how executive management can take advantage of a public company's board of directors. In more general applications, behavioral scientists have been saying for years that small deliberative groups are prone to error in their decision making if they are made up of a majority of members who are similar in position before deliberations.[104] When they are, such groups can fall victim to what is referred to as *group polarization*, the tendency of a small deliberative group with an initial tendency to move in a given direction to move to even more extreme positions in that direction following group deliberations.[105] This problem is especially relevant for groups who are like-minded or possess a shared identity.[106] The corporate board of a public company with a majority of independent directors is no exception to this problem.

It is easy to see how corporate boards could become victims of group polarization. Insider board members and executive management in general will have a greater degree of knowledge and understanding regarding the true state of the company than the independent directors. Board decision making should benefit from this asymmetric distribution of information so long as insiders honestly share information relevant to a prospective decision with the other board members during deliberations.[107] Given this understanding, it is only rational for independent board members to enter board deliberations with the initial tendency to presume that the business judgments of insiders and executive management are correct, creating a group of

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in the context of corporate governance). Dysfunctional deference can be understood as one explanation for why "board capture" occurs. Board capture refers to the alignment of a corporate board with its management. *See* Randall S. Thomas, *Explaining the International CEO Pay Gap: Board Capture or Market. Driven?*, 57 VAND. L. REV. 1171, 1174 n.5 (2004). For an excellent discussion of board capture, see JONATHAN R. MACEY, CORPORATE GOVERNANCE: PROMISES KEPT, PROMISES BROKEN 57-68 (2008).

[104]No one in the legal community has done more to sound the alarm about the problems of small group decision making than Professor Cass Sunstein. *See, e.g.*, Cass R. Sunstein, *Deliberative Trouble? Why Groups Go to Extremes,* 110 YALE L.J. 71, 74-75 (2000) (discussing how group polarization leads to errors); Cass R. Sunstein, *Group Judgments: Statistical Means, Deliberation, and Information Markets*, 80 N.Y.U. L. REV. 962, 966 (2005) (discussing how pre-deliberative tendencies in groups lead to errors in deliberative groups).

[105]Sunstein, *Deliberative Trouble?*, *supra* note 104, at 74. Professor Sunstein notes that the term group polarization is "misleading" as it can be mistakenly interpreted to mean that group members move toward opposite positions. *Id.* at 85.

[106]Cass R. Sunstein & Reid Hastie, *Four Failures of Deliberating Groups* 18, 21 (John M. Olin Law & Econ. Working Paper No. 401 and Public Law & Legal Theory Working Paper No. 215, 2008), *available at* https://ssrn.com/abstract_id=1121400.

[107]Sharfman & Toll, *supra* note 34, at 156.

like-minded people.[108] Moreover, this initial tendency may be supported by a significant number of independent board members who have a shared identity, such as members who are also current or former CEOs. These board members form a dominant "in-group"[109] whose positions may polarize in order to conform to what they believe is the typical position of the other in-group members.[110] Such a scenario promotes the dominant initial position in discussion, limits the argument pool, and proceeds to an extreme as in-group members hear their peer group voice similar positions and gain confidence in their beliefs.[111]

The understanding of how a board can fall victim to dysfunctional deference and group polarization[112] leads to the conclusion that decisions

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[108]*See* Sunstein, *Deliberative Trouble?*, *supra* note 104, at 82 ("When individuals lack a great deal of private information . . . they rely on information provided by the statements or actions of others.").

[109]Sunstein & Hastie, *supra* note 106, at 21.

[110]*Id.*

[111]*Id.*

[112]In the context of approving company-wide compensation policies, it is not hard to see how group polarization may have affected board decision making at Wall Street firms. These firms were run by and employed financially and mathematically sophisticated people who, in turn, produced incredibly large annual profits for the firm. In this regard, it must have been an extremely humbling experience to be on the board of a Wall Street firm through at least 2006. *See* Frank Ahrens, *For Wall Street's Math Brains, Miscalculations; Complex Formulas Used by "Quant" Funds Didn't Add Up in Market Downturn*, WASH. POST, Aug. 21, 2007, at A1; Ronald Alsop, *M.B.A. Track: Wall Street Warms To Finance Degree With Focus on Math*, WALL ST. J., Nov. 14, 2006, at B7. If executive management was inclined to promote and recommend company compensation plans focused on large annual bonuses, it may have been hard for Wall Street boards to say no.

While the focus of this article is not on the motivations of executive management, it is possible to argue that keeping the team together through lavish company-wide compensation during deteriorating economic and financial conditions offers executive management a number of advantages. First, keeping the team together may be critical to what they perceive as the value they provide the firm. For example, what else could have explained the decision of John Thain, the former head of Merrill Lynch, to accelerate $3.6 billion in board approved bonuses to a large number of Merrill Lynch employees just before the company's merger with Bank of America, even though he knew that his company was soon to publicly disclose huge fourth quarter 2008 losses? *See* Farrell, *supra* note 11, at 7; Karen Freifeld & David Mildenberg, *Cuomo Subpoenas Thain and Alphin Over Merrill Bonuses (Update3)*, BLOOMBERG.COM, Jan. 27, 2009, http://www.bloomberg.com/apps/news?pid=20670001&refer=&sid=asBPF7zQ2Jgg. Moreover, in another example of trying to keep "his" team together, Thain was more than willing to radically reduce the combined headcount of the investment banking team, but mainly at the expense of the Bank of America employees. Farrell, *supra* note 11, at 7. Second, executive management may try to keep the team together in order to maintain their large compensation packages since company size is a major determinant of executive compensation. *See* Lucian Bebchuk & Yaniv Grinstein, *Firm Expansion and CEO Pay* 23 (Harvard John M. Olin Ctr. for Law, Econ., & Bus. Discussion Paper Series, Discussion Paper No. 533, 2007), *available at* http://ssrn.com/abstract=838245. Third, keeping the team together will help maintain the reputations of top management as capable corporate leaders of large financial organizations. Allowing for massive defections may have a negative impact on their

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

In addition, because of the potential for group polarization or dysfunctional deference, recommendations of executive management to spend large amounts of company resources in the pursuit of acquisitions that may significantly increase the business or financial risk of the corporation may also indicate opportunistic rent seeking behavior. While the money spent does not go directly into the pockets of executive management, they do end up with an increased amount of assets under their control, helping them enhance their managerial reputations and justify increased compensation based on an increase in firm size.[113]

IV. THE VALUE OF CENTRALIZED AUTHORITY AND CORPORATE LAW

The decisions identified above are not meant to imply that such decisions will necessarily lead to director liability or that we want directors to avoid making them. Doing so would jeopardize the value of centralized authority that is so critical to the successful operation of the public company.

Why corporate law places so much emphasis on the value of board authority can best be explained in terms of the unique organizational efficiencies that the corporate form provides to a public company.[114] These efficiencies involve the hierarchical nature of the corporate form as reflected in the centralized authority of the corporate board. They are manifested by the ability of a public company's board to (1) "act as a mediating hierarchy to minimize agency costs caused by team production," which has already been discussed, and (2) "efficiently filter information in its decision making process."[115]

This second efficiency is derived from Professor Kenneth Arrow's theory of organizational authority.[116]

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reputations. *See* Sandeep Gopalan, *Shame Sanctions and Excessive CEO Pay*, 32 DEL. J. CORP. L. 757, 765-67 (2007).

[113]Company size is a major determinant of executive compensation. *See* Bebchuk & Grinstein, *supra* note 112, at 23.

[114]Sharfman, *supra* note 35, at 309.

[115]*Id.* at 290.

[116]KENNETH J. ARROW, THE LIMITS OF ORGANIZATION 68 (1974). Professor Michael Dooley was the first to make the connection between the work of Kenneth Arrow and the structure of Delaware corporate law. *See* Dooley, *supra* note 2, at 467. Based on that foundation, Professor Stephen Bainbridge created his director primacy model of corporate governance. *See* Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547, 574 (2003).

Arrow's discussion of authority starts out with the basic proposition that "authority is needed to achieve a coordination of the activities of the members of the organization." But, more importantly, centralized authority enhances organizational efficiency. According to Arrow, efficiency is created in a large organization because "the centralization of decision-making serves to economize on the transmission and handling of information." Arrow's theory on how centralized authority creates value is based on four propositions:

1. Since the activities of individuals interact with each other, being sometimes substitutes, sometimes complements, and frequently compete for limited resources, joint decision on the choice of individuals' activities will be superior to separate decisions.

2. The optimum joint decision depends on information which is dispersed among the individuals in the society.

3. Since transmission of information is costly, in the sense of using resources, especially the time of the individuals, it is cheaper and more efficient to transmit all the pieces of information once to a central place than to disseminate each of them to everyone.

4. For the same reasons of efficiency, it may be cheaper for a central individual or office to make the collective decision and transmit it rather than retransmit all the information on which the decision is based.

For an organization to be successful in its decision making, its decisions must be based on adequate information and made in a timely manner. This requires the organization "to facilitate the flow of information to the greatest extent possible." Such facilitation requires "the reduction of the volume of information while preserving as much of its value as possible." Centralized authority allows for "superior efficiency" by minimizing the number of communication channels required in a large organization.[117]

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[117]Sharfman, *supra* note 35, at 294-95 (quoting ARROW, *supra* note 116, at 68-70) (footnotes omitted).

Furthermore, the value of centralized authority provides extra benefits to widely held public companies. According to Professor Dooley, the value of centralized authority to a corporation is magnified as the knowledge and interests of its members diverge. In a public company, information and interests differ between management and shareholders.[118] Especially where there are a large number of shareholders, it is much more efficient for a centralized authority with an overwhelming information advantage, such as the board of directors, to make corporate decisions rather than shareholders.[119]

Delaware corporate law reflects and promotes the value of centralized authority by not only providing managerial authority to a small centralized group of individuals, the board of directors, but also by making it very difficult for stockholders or the courts to second-guess board decisions through judicial creations such as the BJR.[120] As so well stated by the Delaware Supreme Court in *Zapata Corp. v. Maldonado*:[121]

> The "business judgment" rule is a judicial creation that presumes propriety, under certain circumstances, in a board's decision. Viewed defensively, it does not create authority. In this sense the "business judgment" rule is not relevant in corporate decision making until after a decision is made. It is generally used as a defense to an attack on the decision's soundness. The board's managerial decision making power, however, comes from § 141(a). The judicial creation and legislative grant are related because the "business judgment" rule evolved to give recognition and deference to directors' business expertise when exercising their managerial power under § 141(a).[122]

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

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

[120]Dooley, *supra* note 2, at 467, 471.

[121]430 A.2d 779 (Del. 1981).

[122]*Id.* at 782 (footnotes omitted).

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

In sum, the value of centralized authority, reflected in the two organizational efficiencies described above, create a strong presumption that the laws of corporate governance should not interfere with the corporate board's decision making process.[123]

V. THE VALUE OF ACCOUNTABILITY

The discussion thus far is not meant to suggest that the corporate board of a public company should be allowed to wield its authority without any accountability. The corporate board needs to be held accountable for its decisions or else it may act irresponsibility with the "likelihood of unnecessary error."[124] Moreover, "unaccountable authority may be exercised opportunistically."[125] Therefore, it is legitimate to criticize such authority and put into place some sort of "corrective mechanism."[126]

Nevertheless, the fear is that in the process of trying to correct errors resulting from irresponsible decisions, "the genuine values of authority" will be destroyed.[127] Such "a sufficiently strict and *continuous* organ of responsibility can easily amount to a denial of authority."[128] Arrow suggests, "[I]f every decision of A is to be reviewed by B, then all we have really is a shift in the locus of authority from A to B and hence no solution to the original problem."[129]

This understanding of the value of centralized authority is consistent with the lessons learned from *Van Gorkom*.[130] In *Van Gorkom*, the Delaware Supreme Court put teeth into the "informed" element of *Aronson*'s BJR formulation[131] by creating what appeared to be a broad but reasonable

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[123]Sharfman, *supra* note 35, at 290.

[124]ARROW, *supra* note 116, at 73-74.

[125]Stephen M. Bainbridge, *The Business Judgment Rule as Abstention Doctrine*, 57 VAND. L. REV. 83, 107 (2004).

[126]ARROW, *supra* note 116, at 75.

[127]*Id.* at 78.

[128]*Id.* (emphasis added).

[129]*Id.*

[130]Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985). For a detailed discussion of the negative effects of the decision, especially on the value of centralized authority, see Sharfman, *supra* note 35.

[131]*See* Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984).

constraint on corporate board discretion in the decision making process.[132] As it was perceived to apply to all board decisions in general, the decision backfired on the court in a big way.[133] Directors threatened to resign because of the perceived increase in liability, and when shareholders had the opportunity to amend their charters with exculpation clauses[134] so that directors could be relieved of liability for duty of care violations arising out of the *Van Gorkom* decision, they did not hesitate to do so.[135] For example, Professor Lawrence Hamermesh reported that out of a sample of one hundred Fortune 500 companies, ninety-eight had adopted an exculpatory provision. Furthermore, each of the fifty-nine Delaware corporations in the sample had such a provision in their corporate charters.[136] Thus, in order for a corrective mechanism to be of value to the organization, it must be applied intermittently.[137]

The denial of authority, and thus the value of centralized authority, is truly the issue when evaluating whether or not courts should require a board to fulfill an enhanced duty when making decisions that on their face implicate opportunistic rent seeking behavior. Yet our recent financial crisis has revealed a weakness in corporate governance that needs to be addressed.

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[132]*See Van Gorkom*, 488 A.2d at 893 (holding that directors breached their duty of care by failing "to inform themselves of all information reasonably available to them and relevant to their decision").

[133]As is well known, the *Van Gorkom* decision has been criticized heavily. *See, e.g.*, Sharfman, *supra* note 35, at 289 (noting that prominent legal scholars have criticized *Van Gorkom*).

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

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

Id.

[135]*See* Lawrence A. Hamermesh, *Why I Do Not Teach* Van Gorkom, 34 GA. L. REV. 477, 497-503 (2000) (listing companies that amended their charter to include a section 102(b)(7) provision).

[136]*Id.*

[137]ARROW, *supra* note 116, at 78. According to Arrow, this intermittent application of accountability

> could be periodic; it could take the form of what is termed "management by exception," in which authority and its decisions are reviewed only when performance is sufficiently degraded from expectations; or it could take the form of review and deeper study of a random sample of decisions or periods.

Id.

It is not desirable to have corporate boards approving compensation policies or other types of cash outflows that can be detrimental to their firms because their role as mediating hierarchies compels them to yield to the negotiating power of one specific type of stakeholder. It is also not desirable if group polarization or dysfunctional deference helps push directors in the direction of approving transactions that involve executive management. Accountability must have its place in this board room dilemma, but *only* if corporate law can adequately accommodate the value of centralized authority.

VI. REQUIRING AN ENHANCED DUTY FOR DECISIONS THAT IMPLICATE BOTH OPPORTUNISTIC RENT SEEKING BEHAVIOR AND THE FINANCIAL HEALTH OF THE FIRM

Wall Street compensation policies have revealed a weakness in the ability of corporate boards to act as mediating hierarchies. Because corporate law created the ability of corporate boards to act as mediating hierarchies, we must first look to corporate law to see if it can provide a solution. Requiring an enhanced duty by the board when it contemplates decisions that on their face implicate both opportunistic rent seeking behavior and the financial health of the firm is the proposed way to fix the problem. Enhanced duties are not to be thought of as "unique fiduciary obligations," but as court guidance on how a public company's board should fulfill its duties of care and loyalty in the context of these decisions.[138] The result, as proposed below, is a small reduction in the authority of corporate boards under a relatively narrow fact pattern. However, it is still necessary that the efficiency gains from this increase in accountability actually exceed the efficiency loss from the corresponding decrease in board authority. If not, a change in corporate law will only make matters worse.

A. *A Proposed Standard of Conduct*

According to Professor Melvin Eisenberg, "A standard of conduct states how an actor should conduct a given activity or play a given role."[139] An enhanced duty is essentially the standard of conduct that is expected of the board when dealing with decisions that on their face implicate

[138]Ryan v. Lyondell Chem. Co., No. 3176-VCN, 2008 WL 2923427, at *2 (Del. Ch. July 29, 2008) (citing Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986)) (basing the court's decision in the context of the enhanced duties under *Revlon*), *reprinted in* 34 DEL. J. CORP. L. 333, 336 (2009), *rev'd*, 970 A.2d 235 (Del. 2009).

[139]Eisenberg, *supra* note 42, at 437 (emphasis omitted).

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

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

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

B. *A Standard of Review*

Professor Eisenberg also states, "A standard of review states the test a court should apply when it reviews an actor's conduct to determine whether to impose liability or grant injunctive relief."[140] Under corporate law, it is necessary to have standards of review that diverge from standards of conduct because corporate actors necessarily make decisions in a world of imperfect information. Corporate actors take on roles, such as board members, where the potential negative outcomes of their decisions may far outweigh the potential rewards for taking on such roles; and there is a need for corporate stakeholders to respect the value of corporate authority, right or wrong.[141]

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[140] *Id.* (emphasis omitted).
[141] *Id.* at 437-38.

Van Gorkom's gross negligence standard of review for being informed when making a business decision is a classic example of where the standard of review diverged from the standard of conduct.[142]

The development of a standard of review moves the analysis from the conceptual to the pragmatic. But before a standard of review can be developed, a tool of accountability needs to be identified. At this time, "good faith" is the only tool of accountability that is realistically available to the Delaware courts. This is so for two basic reasons. First, exculpation clauses under Delaware Code section 102(b)(7) have become so prevalent that it is very difficult for shareholders to pursue duty of care liability claims under *Van Gorkom*.[143] Second, because we are dealing with a board that is presumably independent and disinterested, claims that the directors have breached their duty of loyalty as a result of conflicts of interest or self-dealing cannot be made. That leaves good faith as the tool of accountability for enforcing the proposed enhanced duties.

1. The *Lyondell* Litigation

Fortunately, clarity in how good faith can be used in enforcing the proposed enhanced duties has already been provided by the Delaware Supreme Court in *Lyondell Chemical Co. v. Ryan*,[144] a recent case involving a claim that the directors breached their duty of good faith by not adequately performing their *Revlon* duties (duties that require a board "when it undertakes a sale of the company, to set its singular focus on seeking and attaining the highest value reasonably available to the stockholder").[145]

a. *The Chancery Court Decision*

In the underlying Chancery Court decision, *Ryan v. Lyondell Chemical Co.*,[146] the court denied a motion for summary judgment because the record did not show any evidence that the board, both independent and disinterested, attempted to adequately perform its *Revlon* duties.[147] The

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[142]Smith v. Van Gorkom, 488 A.2d 858, 873 (Del. 1985).

[143]*See supra* text accompanying notes 131-38.

[144]Lyondell Chem. Co. v. Ryan, 970 A.2d 235 (Del. 2009).

[145]Ryan v. Lyondell Chem. Co., No. 3176-VCN, 2008 WL 2923427, at *2 (Del. Ch. July 29, 2008) (citing Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986)), *reprinted in* 34 DEL. J. CORP. L. 333, 336 (2009), *rev'd*, 970 A.2d 235 (Del. 2009).

[146]*Id.* at *11-12, *reprinted in* 34 DEL. J. CORP. L. at 361.

[147]*Id.* at *16, *reprinted in* 34 DEL. J. CORP. L. at 361. All eleven members of the board were independent except for the chairman who was also the chief executive officer. *Id.* at *4,

critical point for the Chancery Court was that these were a known set of board duties requiring certain board conduct, performance of which was not found in the record. Without such evidence on the record, the court felt the board may have violated its duty of good faith.[148] Because the board's duty of good faith was in question, the defendants' argument that the corporation's exculpation clause would relieve them of liability and provide the legal basis for granting the motion for summary judgment did not apply.[149] Therefore, the motion for summary judgment could not be granted.[150]

The court cited for its authority *Stone v. Ritter*,[151] a case where the Delaware Supreme Court stated: "Where directors fail to act in the face of a known duty to act, thereby demonstrating a conscious disregard for their responsibilities, they breach their duty of loyalty by failing to discharge that fiduciary obligation in good faith."[152] This was a statement made in the context of board oversight where the board was accused of not having a system in place to monitor for violations of law.[153] Nonetheless, this statement was derived from the dicta of *Disney*, a decidedly non-oversight case, where the court said, "A failure to act in good faith may be shown . . . where the fiduciary intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties."[154] By utilizing the statement from *Stone v. Ritter* as authority, the Chancery Court was logically applying what it believed to be the Delaware Supreme Court's understanding of good faith duties in the context of both oversight and non-oversight fact patterns.

Moreover, it may be the only approach possible that allows for a clear distinction between a lack of due care and a lack of good faith so desired by the Delaware Supreme Court in *Disney*:

> From a broad philosophical standpoint, that question is more complex than would appear, if only because (as the Chancellor and others have observed) "issues of good faith are (to a certain degree) inseparably and necessarily intertwined with the duties of care and loyalty . . . ." But, in the pragmatic, conduct-

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reprinted in 34 DEL. J. CORP. L. at 338. There was no evidence that the independent directors were improperly interested. *Id.* at *10, *reprinted in* 34 DEL. J. CORP. L. at 349-50.

[148] *Id.* at *18, *reprinted in* 34 DEL. J. CORP. L. at 366.

[149] *Ryan*, 2008 WL 2923427, at *18. *reprinted in* 34 DEL. J. CORP. L. at 366.

[150] *Id.* at *18-19, *reprinted in* 34 DEL. J. CORP. L. at 366-67.

[151] Stone v. Ritter, 911 A.2d 362 (Del. 2006).

[152] *Ryan*, 2008 WL 2923427, at *19 (citing *Stone*, 911 A.2d at 370), *reprinted in* 34 DEL. J. CORP. L. at 367.

[153] *See Stone*, 911 A.2d at 369-70.

[154] *In re* Walt Disney Co. Deriv. Litig., 906 A.2d 27, 67 (Del. 2006).

> regulating legal realm which calls for more precise conceptual line drawing, the answer is that grossly negligent conduct, without more, does not and cannot constitute a breach of the fiduciary duty to act in good faith. The conduct that is the subject of due care may overlap with the conduct that comes within the rubric of good faith in a psychological sense, but from a legal standpoint those duties are and must remain quite distinct. Both our legislative history and our common law juris-prudence distinguish sharply between the duties to exercise due care and to act in good faith, and highly significant consequences flow from that distinction.[155]

Abdication of duties can straddle either side of the fence, but because of exculpation clauses that cut off duty of care claims for an independent and disinterested board, it is pragmatically necessary to keep it on the side of a lack of good faith and thereby allow it to be utilized as a tool of accountability.[156]

b. Lyondell v. Ryan

Upon acceptance of an interlocutory appeal that was originally denied by the chancery court, the Delaware Supreme Court reversed the decision and remanded the case back to the chancery court stating that the defendants were entitled to summary judgment.[157] The court found no evidence from which to draw the conclusion that the directors knowingly ignored their responsibilities.[158] The Delaware Supreme Court agreed with the chancery court on the important point that "bad faith will be found if a 'fiduciary intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties,'"[159] but disagreed with what *Revlon* duties required and the standard of review applied by the trial court.

First, the supreme court noted that there is "only one *Revlon* duty" and that duty requires the board "to get the best price for the stockholders at a sale of the company."[160] This means there are "no legally prescribed steps

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[155] *Id.* at 65 (citations omitted).

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

[157] Lyondell Chem. Co. v. Ryan, 970 A.2d 235, 237 (Del. 2009).

[158] *Id.*

[159] *Id.* at 243 (quoting *Disney*, 906 A.2d at 67).

[160] *Id.* at 242 (quoting Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173,

that directors must follow to satisfy their *Revlon* duties."[161] Thus, "the directors' failure to take any specific steps during the sale process could not have demonstrated a conscious disregard of their duties."[162] This approach is consistent with the proposed enhanced duty for decisions that on their face implicate opportunistic rent seeking behavior. There are no prescribed steps, only that the board of a public company must consider the financial effects of implementing these decisions.

Second, and most importantly, the Delaware Supreme Court applied a standard of review that is consistent with this article's emphasis on the value of centralized authority:

> Directors' decisions must be reasonable, not perfect. In the transactional context, an extreme set of facts is required to sustain a disloyalty claim premised on the notion that disinterested directors were intentionally disregarding their duties. The trial court denied summary judgment because the Lyondell directors' unexplained inaction prevented the court from determining that they had acted in good faith. But, if the directors failed to do all that they should have under the circumstances, they breached their duty of care. Only if they knowingly and completely failed to undertake their responsibilities would they breach their duty of loyalty. The trial court approached the record from the wrong perspective. Instead of questioning whether disinterested, independent directors did everything that they arguably should have done to obtain the best sale price, *the inquiry should have been whether those directors utterly failed to attempt to obtain the best sale price.*[163]

This standard of review sets an extremely high bar for establishing director liability.[164] It is also consistent with and owes much to Chancellor William Allen's famous dicta in *Caremark.*[165]

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182 (Del. 1986)).

[161] *Lyondell*, 970 A.2d at 243.

[162] *Id.*

[163] *Id.* (citations and quotations omitted) (emphasis added).

[164] Police & Fire Ret. Sys. of Detroit v. Bernal, No. 4663-CC, 2009 WL 1873144, at *3 (Del. Ch. June 26, 2009) (noting that because of *Lyondell*, "injunctive relief may be the only relief reasonably available to shareholders for certain breaches of fiduciary duty in connection with a sale of control transaction"); *see also* Amazon.com, Inc. v. Hoffman, No. 2239-VCN, 2009 WL 2031789, at *2-3 (Del. Ch. June 30, 2009) (applying the recently established good faith standard of review to support defendants' motion to dismiss).

[165] *See In re* Caremark Int'l Inc. Deriv. Litig., 698 A.2d 959, 970-71 (Del. Ch. 1996).

2. A *Caremark* Approach to Good Faith

Understanding *Caremark* is critical to understanding the reasoning beyond *Lyondell* and how good faith can be used to enforce the proposed enhanced duty without crippling the value of centralized authority. In *Caremark*, Chancellor Allen identified a new affirmative duty to monitor corporate compliance with "applicable legal standards" whether or not the board has been given notice of any wrongdoing on the part of the company's employees:

> [A] director's obligation includes a duty to attempt in good faith to assure that a corporate information and reporting system, which the board concludes is adequate, exists, and that failure to do so under some circumstances may, in theory at least, render a director liable for losses caused by non-compliance with applicable legal standards.[166]

But even in his description of this new duty, he was already signaling that the standard of review needed to be quite lenient, and so it was "only a sustained or systematic failure of the board to exercise oversight—*such as an utter failure to attempt to assure a reasonable information and reporting system exits*—will establish the lack of good faith that is a necessary condition to liability."[167] It took ten years, but this standard won the day when the Delaware Supreme Court adopted it in *Stone v. Ritter*.[168]

In *Caremark*, Chancellor Allen explained that he wanted a board to be more actively involved in company oversight and monitoring.[169] However, this objective was tempered by creating a good faith standard of review that made it extremely difficult to find director liability: [170]

> Such a test of liability—lack of good faith as evidenced by sustained or systematic failure of a director to exercise reasonable oversight—is quite high. But, a demanding test of liability in the oversight context is probably beneficial to corporate shareholders as a class, as it is in the board decision context,

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[166] *Id.* at 970.

[167] *Id.* at 971.

[168] *See* Stone v. Ritter, 911 A.2d. 362, 370 (Del. 2006).

[169] Jennifer Arlen, *The Story of Allis-Chalmers, Caremark, and Stone: Directors' Evolving Duty to Monitor* 3 (NYU Ctr. for Law, Econ. & Org. Law & Econ. Research Paper Series, Working Paper No. 08-57, Nov. 2008), *available at* http://ssrn.com/abstract=1304272.

[170] *In re Caremark*, 698 A.2d at 971.

> since it makes board service by qualified persons more likely, while continuing to act as a stimulus to good faith performance of duty by such directors.[171]

Chancellor Allen demonstrated that in a standard of review analysis, definitions of legal terms such as good faith are not created based on etymology, but on what is needed to allow corporate law to fulfill its efficiency objectives. His goal was to use oversight duties to enhance shareholder value without significantly reducing the pool of qualified persons willing to serve on a corporate board. To Chancellor Allen, that meant that the zone of board liability for a breach of good faith needed to be extremely small to optimize the efficiency of a board's oversight duties.

Moreover, Chancellor Allen's dicta in *Caremark* can be understood as being consistent with Kenneth Arrow's theory of centralized authority. According to Professor Arrow, as applied in the corporate context, board accountability must be applied intermittently and with restraint so as not to deny the board its rightful authority to make corporate decisions.[172] If not, a "continuous organ of responsibility can easily amount to a denial of authority."[173] That is, fiduciary duties do not have to put into place exact punishment for all breaches, or for the overwhelming majority of them, only that they encourage board behavior that results, on a net basis, in enhancing the efficiency of the corporate form. And fiduciary duties must be applied with a very light touch, or else the value of centralized authority may be diminished to such an extent that a net loss in efficiency will certainly result. This is perhaps the ultimate lesson learned by the Delaware Supreme Court as a result of its decision in *Van Gorkom* and what Chancellor Allen was trying to teach in *Caremark*.

3. Applying *Lyondell* to the Proposed Enhanced Duty

Lyondell is a landmark case in Delaware corporate law jurisprudence because it expands Chancellor Allen's understanding of good faith liability from board oversight to the enhanced duties required under *Revlon*. It therefore provides an opportunity for his approach to be applied to other types of enhanced duties, such as the enhanced duty proposed in this article.

Because of its critical importance to the survival and financial health of the firm, it is argued here that the proposed enhanced duty associated with

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[171] *Id.* (emphasis omitted).
[172] ARROW, *supra* note 116, at 78.
[173] *Id.*

decisions that on their face implicate both opportunistic rent seeking behavior and the financial health of the firm should also be treated in the same manner as the Delaware Supreme Court treated the corporate board's *Revlon* duties in *Lyondell*. In such decisions, the duty required is to consider the financial effects on the company from implementing these decisions. Like *Revlon* duties, this duty is known, but unspecified, and if a court of inquiry finds that a board utterly failed to attempt to perform this duty, then director liability should follow.

If it cannot be shown that a board utterly failed in its attempt to fulfill the duty associated with such decisions, then the review for director liability would come under *Van Gorkom* for a determination of whether the board was properly informed when it made its decision. If the company has an exculpation clause in its charter, then the board will be absolved of liability even if the facts show that the board had violated its duty of care. Such an approach fits neatly into the doctrine of good faith that the Delaware courts are now applying.

Consistent with the approach taken in *Caremark*, where new board oversight duties were identified in the context of changing times, our changing times require new duties of directors. Even so, the proposed enhanced duty may seem trivial given the remoteness of director liability. But it is not. Tools of accountability must be structured so as to maximize the efficiency of board decision making—even if the zone of liability appears extremely small. As the Delaware Supreme Court learned from *Van Gorkom*, even gross negligence can be an over-burdensome standard of director liability. To this end, the good faith standard of review for the proposed enhanced duty provides a very small zone of liability, a standard that is both consistent with Professor Arrow's theory of centralized authority and with the need to provide the corporate board with the incentive to push back against a powerful shareholder in the board's role as a mediating hierarchy. Yes, the possibility of director liability may be remote, but this must be balanced with the understanding that any risk adverse independent board member will most likely not want to ignore the possibility, if only a small one, of a large personal loss for ignoring this new enhanced duty, and therefore will be strongly motivated to comply with it.

Moreover, there is another aspect of the proposed enhanced duty that is worth noting. Very soon after *Van Gorkom*, Dean Bayless Manning[174] suspected that the degree of scrutiny provided by the courts in BJR cases

[174]Bayless Manning was Dean of Stanford Law School. *See* BAYLESS MANNING & JAMES J. HANKS, JR., LEGAL CAPITAL, at iii (1990).

would vary according to the issues at stake.[175] He suggested that major business decisions that come up on a regular basis, such as whether production should be significantly expanded or contracted ("enterprise issues"), would receive less scrutiny by the courts than decisions that have a direct impact on stock ownership, such as whether to accept a merger proposal ("ownership claim issues").[176] Dean Manning's vision has become a reality.[177] The proposed enhanced duty, however, is an exception to this reality. It is required because of its critical importance to the survival and financial health of the firm.

VII. CONCLUSION

Judge Richard Posner has argued that the recent financial crisis and resulting economic downturn was a failure of capitalism, caused by an inherently unstable financial sector.[178] This instability was the direct result of behavior such as the pursuit of fake alpha, where the remote chance of disaster is discounted or ignored.[179] For the individuals involved, the potential compensation to be earned before the likely materialization of the risk makes the risk well worth taking. Such behavior is rational, though undesirable. How this behavior can be changed on a systemic basis is beyond the reach of corporate law. However, such behavior has put a focus on the decisions of Wall Street firms to voluntarily transfer huge amounts of capital, even in times of deteriorating financial and economic conditions, to employees who have compensation arrangements that make them the equal, if not more, to shareholders as residual claimants. These decisions have given us pause to consider whether or not a change in corporate law is necessary to support the ability of these boards to push back against the demands of certain stakeholders who may be in artificially strong negotiating positions *vis-à-vis* the board and other stakeholders.

This article concludes that a change in corporate law is necessary and proposes a new enhanced duty for certain types of board decisions that on their face implicate both opportunistic rent seeking behavior and the financial health of the firm. This enhanced duty is meant to help facilitate the board's role as a mediating hierarchy when dealing with such decisions.

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[175]Bayless Manning, *Reflections and Practical Tips on Life in the Boardroom After* Van Gorkom, 41 BUS. LAW. 1, 5 (1985).

[176]*Id.* at 5-6.

[177]Mary Siegel, *The Erosion of the Law of Controlling Shareholders*, 24 DEL. J. CORP. L. 27, 44 (1999).

[178]POSNER, *supra* note 18.

[179]*Id.*

Finally, the proposed enhanced duty is not meant to interfere with a corporate board's freedom to contract with its labor force or executive management. For example, if the labor markets dictate that such compensation policies must continue for Wall Street firms to remain competitive, then the author does not believe that it is not up to corporate law to interfere. This approach should be self-evident as the good faith standard of review that is used to determine whether the proposed enhanced duty has been properly implemented is highly deferential to directors and therefore does not create a threat to the value of centralized authority.