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EMPOWERING COURTS IN CORPORATE LAW

Julian Velasco*

Remarks to the Journal of Corporation Law, Spring 2016

As you know, I am a corporate law scholar; but I also like to think of myself as a fiduciary law scholar. What is fiduciary law? It is not exactly an area of law in the conventional sense that contracts, torts, and property are. Fiduciary law may better be understood as a set of legal principles that are applied in various substantive areas of law—including, for example, trusts, agency, and corporate law. Each application, or instantiation, is somewhat unique, and so it might be easy to conclude that there is no such thing as fiduciary law.[1] However, there are general principles that are applied in different ways, so the concept of fiduciary law remains meaningful.

What are these principles of fiduciary law? A rough sketch of the contours would be as follows:

> A fiduciary relationship is a legally recognized relationship in which one is given power over the interests of another, who thereby becomes vulnerable to abuse. Although such relationships are risky, they can also be very beneficial. In order to encourage and police such relationships, the law imposes a duty on the first party—the fiduciary—to act in the interests of the second party—the beneficiary . . . . Thus, the raison d'être of fiduciary duties . . . is the protection of the beneficiary from abuse at the hands of the fiduciary.[2]

What duty does the law impose on fiduciaries?

> At the very least, there is a duty of loyalty. With respect to the fiduciary relationship, a fiduciary may not act counter to the interests of the beneficiary. In fact, fiduciaries must avoid conflicts of interest that might tempt them to act against the interests of the beneficiary. . . . There are some who argue that the duty of loyalty is the only true fiduciary duty. However, that is a controversial claim. Almost equal in pedigree and stature to the duty of loyalty is the duty of care. A fiduciary must act (i.e., perform the service in question) diligently, exercising an appropriate level of care and skill. . . . Other duties could be enumerated. In each case, the law protects the beneficiary from abuse at the

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1. *Cf.* Deborah A. DeMott, *Beyond Metaphor: An Analysis of Fiduciary Obligation*, 1988 DUKE L.J. 879, 908 ("fiduciary obligation eludes theoretical capture"); *id.* at 915 ("One could justifiably conclude that the law of fiduciary obligation is in significant respects atomistic.").

2. Julian Velasco, *Fiduciary Duties and Fiduciary Outs*, 21 GEO. MASON L. REV. 157, 159 (2013) (citations omitted).

hands of the fiduciary, in whatever form that abuse might take. [3]

These are the core principles of fiduciary law. How are they implemented in corporate law? Corporate law recognizes the twin duties of care and loyalty,[4] but uniquely treats the two very differently. Cases involving the duty of care receive very deferential review under the business judgment rule[5]—if any at all, in light of exculpation provisions in corporate charters[6]—while cases involving the duty of loyalty receive more demanding review under the entire fairness test.[7] The justification for this dichotomy goes as follows. In cases involving only the duty of care, directors can be trusted because their interests are aligned with those of the shareholders: they both want the company to prosper. Thus, exacting judicial review is unnecessary. In cases involving the duty of loyalty, on the other hand, directors cannot be trusted because their interests conflict with those of the shareholders. Thus, judicial review is necessary.[8]

Because of this dichotomy, corporate law scholars seem to believe that the duty of loyalty is policed with great rigor and that the duty of care is relatively unimportant. I do not agree with that assessment. In my last article, published in this Journal, I argued for the continued importance of the duty of care.[9] In a future article, I plan to follow up with an argument that the duty of loyalty is not enforced as rigorously as is generally believed. But this is not the subject of my address tonight.

My view of fiduciary law generally—and corporate law fiduciary duties specifically—is that fiduciary duties are utterly pervasive and can be summarized faithfully only in the broadest terms: "Simply put, a fiduciary has the duty to act in the interests of the beneficiary in all relevant respects."[10] In other words, both care and loyalty, as well as any other fiduciary duties that exist, are all merely aspects of the one overarching fiduciary duty to pursue the interests of the beneficiary.

In an ideal world, we would police fiduciary duties by reading the fiduciary's mind to answer the question: were you acting entirely in the interests of the beneficiary when you made the decision? If the answer is "yes," then fiduciary duties have been satisfied; if the answer is "no"—including "not entirely"—then fiduciary duties may have been breached. Although this test may seem somewhat fanciful, it is fairly orthodox in principle. To quote an article co-authored by Leo Strine, currently the Chief Justice of the Delaware Supreme Court:

> [O]ne of the most important Delaware corporate lawyers involved in the last comprehensive revision of the [Delaware General Corporation Law], S. Samuel Arsht, was said to have described the essence of Delaware corporate law as follows: "Directors of Delaware corporations can do anything they want, as long as it is not illegal, and as long as they act in good faith." That statement is only

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3. *Id.* at 162.

4. *See* Stone v. Ritter, 911 A.2d 362, 369–70 (Del. 2006). *But see* Julian Velasco, *How Many Fiduciary Duties Are There In Corporate Law?*, 83 S. CAL. L. REV. 1231, 1232–33 (2010).

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

6. *See* DEL. CODE ANN. tit. 8, § 102(b)(7) (West 2015).

7. *See* Weinberger v. UOP, Inc., 457 A.2d 701, 710 (Del. 1983).

8. *See* Julian Velasco, *Structural Bias and the Need for Substantive Review*, 82 WASH. U. L.Q. 821, 834–35 (2004).

9. *See generally* Julian Velasco, *A Defense of the Corporate Law Duty of Care*, 40 J. CORP. L. 647 (2015).

10. *Id.* at 648.

a bit exaggerated.[11]

Arsht's point is essentially the same as mine: what matters most to fiduciary law is that the directors actually be acting in the interests of the shareholders. Obviously, mind-reading is not an option, so other enforcement mechanisms must be considered. Thus, we look for proxies for bad faith, like conflicts of interest and negligence. But we should keep the ultimate goal in mind.

We litigate issues of care and loyalty in order to enforce directors' fiduciary duties. However, litigation is imperfect. Let us set aside for a moment the possibility of error.[12] The fact is, litigation is expensive, and therefore demands a cost-benefit analysis. Moreover, courts have come to believe that litigation has been hijacked by us—the lawyers. Entrepreneurial attorneys are essentially acting as businessmen, making investment decisions with their time and taking the risk of profit and loss on cases.[13] They may advance their own interests by maximizing their fees rather than the recovery for the shareholder plaintiffs. The merits of a case need not matter: an entrepreneurial attorney could just as easily pursue a frivolous case for settlement value as settle a meritorious case for higher attorney's fees. Or so it is believed. Is this descriptively accurate? That is a controversial issue. For present purposes, it does not really matter. What matters is that courts and legislators believe it. And they have responded accordingly.

In order to deal with this problem, lawmakers—both courts and legislatures—have imposed significant restrictions on shareholder litigation. I hinted at these in my last article,[14] and will develop them more fully in my next. But look at the challenges facing shareholder-plaintiffs! In order to bring a derivative action, they face the contemporaneous ownership rule[15] and the demand requirement.[16] In order to plead demand futility, they must make particularized allegations without the benefit of discovery.[17] Even if they manage to clear these hurdles, they may face a special litigation committee that gives the directors a second chance to have the case dismissed.[18] On the merits, they face a divergence between the standards of conduct and standards of review—in other words,

11. Leo E. Strine, Jr., et al., *Loyalty's Core Demand: The Defining Role of Good Faith in Corporation Law*, 98 GEO. L.J. 629, 640 (2010). At the time of the publication of this article, Strine was a Vice Chancellor of the Delaware Court of Chancery.

12. Julian Velasco, *The Role of Aspiration in Corporate Fiduciary Duties*, 54 WM & MARY L. REV. 519, 546–53 (2012).

13. For discussions of the concept of attorneys acting like businessmen, see generally John C. Coffee, Jr., *The Regulation of Entrepreneurial Litigation: Balancing Fairness and Efficiency in the Large Class Action*, 54 U. CHI. L. REV. 877 (1987); Jonathan R. Macey & Geoffrey P. Miller, *The Plaintiffs' Attorney's Role in Class Action and Derivative Litigation: Economic Analysis and Recommendations for Reform*, 58 U. CHI. L. REV. 1 (1991); Roberta Romano, *The Shareholder Suit: Litigation without Foundation*, 7 J.L. ECON. ORG. 55 (1991). For more favorable perspectives, see Myriam Gilles & Gary B. Friedman, *Exploding the Class Action Agency Costs Myth: The Social Utility of Entrepreneurial Lawyers*, 155 U. PA. L. REV. 103 (2006); Brian T. Fitzpatrick, *Do Class Action Lawyers Make too Little*, 158 U. PA. L. REV. 2043 (2010).

14. *See* Velasco, *supra* note 9, at 688–90 (listing restrictions on shareholder litigation).

15. *See* DEL. CODE ANN. tit. 8, § 327 (West 1998).

16. *See* DEL. CH. CT. R. 23.1 (2007).

17. *See* Aronson v. Lewis, 473 A.2d 805, 808 (Del. 1984) ("[D]emand can only be excused where facts are alleged with particularity which create a reasonable doubt that the directors' action was entitled to the protections of the business judgment rule.").

18. *See, e.g.*, Zapata Corp. v. Maldonado, 430 A.2d 779, 788–89 (Del. 1981) (setting forth a two-step test for evaluating decisions of special litigation committees).

they need to establish not merely negligence or a conflict of interests, but gross negligence or a conflict that rises to the level of self-dealing.[19] And gross negligence is available only if the corporation has not adopted an exculpation provision,[20] which it probably has.

Each one of these developments may be perfectly reasonable. However, I would like to suggest that they are excessive in the aggregate. They have created a legal landscape in which it is very difficult for a shareholder to prevail except in the most extreme cases of misconduct. The goal may be to prevent entrepreneurial attorneys from bringing non-meritorious cases, but the side effect is to prevent aggrieved shareholders from bringing many meritorious cases. As a result, directors know they can get away with quite a bit.

Courts may not be worried because they see that, despite their efforts to thwart non-meritorious litigation, they remain swamped with questionable cases.[21] This may lead them to believe that they have not gone too far and, in fact, still have a way to go in curtailing litigation. But this is a non-sequitur: the present system may not only prevent meritorious cases from having a day in court, but actually may make meritorious cases appear to be non-meritorious! The fact that plaintiffs cannot satisfy the requirement for particularized allegations does not mean that there has been no breach of fiduciary duty. Perhaps the requirement could have been satisfied with the benefit of discovery. Or perhaps the plaintiffs could establish negligence or a conflict of interests, but their case is dismissed because they could not establish gross negligence or self-dealing. That might be perfectly legitimate after a trial, but we must remember that we are talking about the pleading stage. In other words, courts should not be surprised to see that most cases cannot even state a claim when the pleading standards have been raised to unparalleled levels. Thus, it may be time to reconsider the costs and benefits of the obstacles placed on derivative litigation.

I hope you will indulge me for a moment as I dwell on some related jurisprudential concepts, involving the dichotomies of rules versus standards and law versus equity. Very briefly, law can take the form of rules or standards.[22] Rules are specific and create bright lines; they are easy to implement. Standards are general and vague; they require more judgment. In corporate law, we have decided that directors' conduct should be governed by standards instead of rules, because detailed rules would inhibit directors' ability to create value for shareholders. That is a defensible choice; I dare say it is the correct one. However, there is a problem if, after choosing standards over rules, we decide not to enforce the standards. I do not mean to suggest that perfect enforcement would be ideal; to the contrary, I have argued the benefits of under-enforcement.[23] Rather, what I mean to say is that the move from rules to standards already accommodates flexibility; thus, a failure to enforce the standards may not so much accommodate further flexibility as simply eliminate law altogether. Understood in this way, it becomes difficult to defend. A similar

19. *See generally* Melvin Aron Eisenberg, *The Divergence of Standards of Conduct and Standards of Review in Corporate Law*, 62 FORDHAM L. REV. 437 (1993).

20. *See supra* note 6 and accompanying text (discussing exculpation provisions).

21. *See In re* Trulia, Inc. Stockholder Litig., 129 A.3d 884, 896 (Del. Ch. 2016) (criticizing "ubiquity of deal litigation"); *In re* Cox Commc'ns, Inc. S'holders Litig., 879 A.2d 605, 617–34 (Del. Ch. 2005) (discussing limited benefits of deal litigation).

22. *See generally* Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 DUKE L.J. 557 (1992) (offering an economic analysis of the consequences of promulgating legal commands as rules or standards); Pierre Schlag, *Rules and Standards*, 33 UCLA L. REV. 379 (1985) (highlighting and explaining the differences between rules and standards).

23. Velasco, *supra* note 12, at 571–80.

narrative can be given for law and equity. In brief, law is universal and *ex ante*, while equity is particular and *ex post*.[24] In corporate law, we have eschewed detailed laws in favor of equitable review—at least with respect to director conduct. Again, that is entirely defensible. However, if there is not going to be much law, then there must be real equity. Closing down the avenues for plaintiffs to seek equitable review means that there is neither law nor equity. Again, this is a result that is difficult to defend.

It may be argued that courts are relatively unnecessary because markets can pick up the slack in policing director misconduct. Much ink has been devoted to this debate, and it cannot be taken up in this address. For our purposes, I would like to make two points. First, although markets can pick up some of the slack, they are not very precise in policing director misconduct. Markets can only be expected to have an impact in the most extreme cases, leaving plenty of opportunities for shareholders to suffer at the hands of directors.[25] Second, it is not clear that courts actually allow markets to perform this role. The most likely avenue for markets to police director misconduct is through the market for corporate control,[26] but the courts have allowed directors to interfere in this market by blocking hostile takeovers.[27] In short, I have come to the conclusion that while markets can have some salutary effect, they cannot supplant law.

So why are courts doing this? Shouldn't we expect courts to be taking on cases rather than deferring? There are a number of possible explanations, including the famous "race for the bottom" theory,[28] and the almost-as-famous "race to the top" theory.[29] Rather than get into that debate, I want to propose a different sort of motivation that is consistent with

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24. *See generally* Christopher Hutton, *Meaning, Time and the Law:* Ex Post *and* Ex Ante *Perspectives*, 22 INT'L J. FOR SEMIOTICS LAW 279, 283–84 (2009) (examining the distinction between law and equity); *see also* Holland v. Florida, 560 U.S. 631, 649–50 (2010) ("[O]ften the 'exercise of a court's equity powers must be made on a case-by-case basis.'") (citations omitted); Nixon v. Blackwell, 626 A.2d 1366, 1378 (Del. 1993) ("These standards are not carved in stone for all cases because a court of equity must necessarily have the flexibility to deal with varying circumstances and issues."); William T. Allen et al., *Function over Form: A Reassessment of Standards of Review in Delaware Corporation Law*, 56 BUS. LAW. 1287, 1294 (2001) ("[T]he almost infinite potential variation in the fact patterns calling for director decisions . . . usually make[s] it impossible for courts to articulate *ex ante* precise guidelines for appropriate fiduciary action in future cases."); Jack B. Jacobs, *The Uneasy Truce Between Law and Equity in Modern Business Enterprise Jurisprudence*, 8 DEL. L. REV. 1, 4 (2005) ("[W]hen I speak of the 'tension between law and equity,' what I am talking about is the antagonism between a system that values a predictable, clear set of rules above all else, and a system that values fairness in the application (or non-application) of those rules in specific cases."); William T. Quillen & Michael Hanrahan, *A Short History of the Delaware Court of Chancery—1792-1992*, 18 DEL. J. CORP. L. 819, 821–22 (1993) ("The secret of Delaware equity rests in two old concepts, . . . Second, equity is the recognition that the universal rule cannot always be justly applied to the special case. Equity is the flexible application of broad moral principles (maxims) to fact specific situations for the sake of justice.").

25. For discussions of the limits of market discipline, see Melvin Aron Eisenberg, *The Structure of Corporation Law*, 89 COLUM. L. REV. 1461, 1488–515 (1989); Melvin Aron Eisenberg, *New Modes of Discourse in the Corporate Law Literature*, 52 GEO. WASH. L. REV. 582, 583–84 (1984).

26. *See generally* Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110 (1965).

27. *See, e.g.*, Air Prods. & Chems., Inc. v. Airgas, Inc., 16 A.3d 48, 105 (Del. Ch. 2011) (discussing whether a board of directors can "just say no" to a tender offer).

28. *See* William L. Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 YALE L.J. 663 (1974).

29. *See generally* Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251 (1977).

both sides. I think the problem can be explained, to a large degree, by acknowledging that courts simply do not want to get involved in business decisions. They want someone else to do it—anyone else, it seems.

There is a great deal of logic and virtue to this position. By statute, "[t]he business and affairs of every corporation . . . shall be managed by or under the direction of a board of directors"[30]—not by courts. Moreover, the courts realize that they are not business experts, and should not be interfering in business decisions.[31] I could go on with the various justifications, but they are already familiar to you.[32] Normally, directors are best suited to make business decisions; courts are not. However, courts are not the very worst decision makers; conflicted or unfaithful directors are even worse. That is why courts are sometimes called upon to decide cases, and why they must do so. The alternative is to leave shareholders vulnerable to abuse. If shareholders challenge a director decision and the courts refuse to involve themselves, they are deciding in favor of directors just as surely as they would be deciding in favor of shareholders if they were to step in. In that sense, courts cannot avoid making decisions. So they are right to be reluctant to make substantive business decisions, but they would be wrong to refuse to decide cases when the circumstances require.

Nevertheless, the reluctance is real. Any proposed solution must take this into account. We need to find the sweet spot: the level of enforcement that optimizes outcomes in light of judicial competencies and capacities. This is, of course, an enormous issue—one that I cannot resolve in this address. But I do hope to be helpful.

Let me take a moment to explore judicial reluctance in the context of one particularly vexing issue: executive compensation. Courts pretty much refuse to consider excessive compensation claims, regardless of the circumstances. It is possible to explain this formally with reference to legal doctrine: compensation is quintessentially a business decision that belongs to directors.[33] But that is wholly unsatisfying in light of the obvious excesses, inadequacies of process, and structural bias. Structural bias, as you may know, is "the prejudice that members of the board of directors may have in favor of one another and of management."[34] Many scholars have argued that structural bias creates a real conflict of interest for directors when dealing with executives, but most courts have found that it does not rise to the level of self-dealing.[35] Nevertheless, I have no doubt that courts realize that executive compensation is a problem—both in theory and in fact. But it is not at all clear what the judicial solution might be.

Courts are not suited to make the executive compensation decisions that they would be called upon to make if they ventured down this path. Moreover, there would be no theoretical limit to their involvement. If directors are considered conflicted in making

30. DEL. CODE ANN. tit. 8, § 141(a) (West 2016).

31. *See* Brehm v. Eisner, 746 A.2d 244, 263–64 (Del. 2000) (discussing judicial deference to director determinations on executive compensation).

32. *See* Velasco, *supra* note 8, at 830–34 (outlining justifications for the business judgment rule).

33. *See Brehm*, 746 A.2d at 263 ("[T]he size and structure of executive compensation are inherently matters of judgment.").

34. Velasco, *supra* note 8, at 824.

35. *See, e.g.*, Aronson v. Lewis, 473 A.2d 805, 815 n.8 (Del. 1984) ("The difficulty with structural bias in a demand futile case is simply one of establishing it in the complaint . . . ."); Velasco, *supra* note 8, at 840–53 (discussing court treatment of structural bias).

executive compensation decisions, then this will be true in every instance. Judicial review would be required in every compensation decision in every corporation in every year. This simply cannot be! It is the logical equivalent of *reductio ad absurdum*: if your logic leads you to that conclusion, then your logic must be rejected. So, if there is no judicial solution, then perhaps the courts are justified in not getting involved—even if the result is to allow misconduct to go relatively unchecked.

However, it is not clear to me that there is no judicial solution even in executive compensation, much less in other, less problematic cases. So the question becomes this: how can we empower courts to do their job? The legal scholar's first instinct is to develop a better substantive rule of law. I am prone to this bias myself. I do not mean to denigrate the value of getting the law correct, and I will surely propose changes to substantive law in the future. However, tonight I want to suggest that we look in another direction. I think it may be helpful to search for judicial tools other than better substantive law. After all, the general premises of corporate law are fairly solid. While improvements could be made, it is possible that we are reaching a point of marginal returns. I am not sure I believe that, but I will accept it for the moment and look elsewhere for a solution.

How can we empower courts to do the job that the substantive law intends them to do? I have two proposals that may be helpful. The first is fairly straightforward: courts should consider being more liberal with injunctive and declaratory relief. The second is more complicated: courts sitting in equity should pay more attention to the larger issues involved rather than focus on the specific facts of the case. Allow me to explain.

First, injunctive and declaratory relief. Part of the problem with litigation is the fear that, especially in large public corporations, damages claims could be ruinous for directors. The fear of liability, in turn, might make directors overly cautious. Shareholders don't want cautious directors; they want directors willing to take appropriate entrepreneurial risks in order to achieve greater returns. Thus, limiting damages claims can help shareholders by making directors more willing to take appropriate risks.[36] Although this makes sense, it only applies to damages claims. It should have no application to injunctions or declaratory judgments because there is no risk of ruinous liability. Thus courts could give alternative relief without jeopardizing value creation in this way. This realization could be a means to empower courts to protect shareholder interests.

It is possible that such relief would be useless. For example, many commentators have complained that derivative litigation often leads to settlements involving meaningless structural changes.[37] It would not be an improvement to have courts issue similar injunctions. On the other hand, it is possible that such relief could be overly aggressive. If the courts were to start to micromanage corporations by way of injunctive orders, there

36. *See In re* Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 967 n.16 (Del. Ch. 1996) ("If those in charge of the corporation are to be adjudged personally liable for losses . . . based upon what . . . persons of ordinary or average judgment . . . regard as 'prudent[,]' 'sensible[,]' or even 'rational,' such persons will have a strong incentive at the margin to authorize less risky investment projects."); Gagliardi v. TriFoods Int'l, Inc., 683 A.2d 1049, 1052 (Del. Ch. 1996) ("[D]irectors will tend to deviate from this rational acceptance of corporate risk if in authorizing the corporation to undertake a risky investment, the directors must assume some degree of personal risk relating to ex post facto claims of derivative liability for any resulting corporate loss."); Joy v. North, 692 F.2d 880, 886 (2d Cir. 1982) ("[B]ecause potential profit often corresponds to the potential risk, it is very much in the interest of shareholders that the law not create incentives for overly cautious corporate decisions.").

37. *See* sources at *supra* notes 13–21.

would clearly be a problem. But surely there is room in between the extremes. For example, if directors were to breach their fiduciary duties in a situation where damages are unavailable or undesirable, the court might be able to issue an injunction preventing the board from engaging in such activities in the future. An injunction might not be a viable option in every situation, of course, but it would surely be helpful in some. Alternatively, the court could structure other injunctive relief that would be designed to prevent mischief in the future.

To illustrate, let us reconsider the issue of executive compensation. Assume that directors were grossly negligent in awarding a clearly excessive compensation package. An exculpation provision would prevent the recovery of monetary damages from the directors. It would not necessarily prevent recovery from the executives in question,[38] but let us assume that is also unavailable. Nevertheless, it might be possible to craft an injunction to help prevent similar problems in the future. For example, a court could require the compensation committee, in the future, to consider, formally and in writing, alternative compensation approaches, scenario analyses, and/or comparison of historical predictions versus actual outcomes. Such requirements would help directors to satisfy their duty of care in the future, while also providing a paper trail for accountability. In certain cases, a court could forbid the committee to employ devices that were believed to have caused mischief; examples might include no-fault termination clauses, automatic bonuses, or un-indexed stock options. Or a court could forbid the negligent board members from serving on the compensation committee in the future. Other possibilities exist, and every injunction should be tailored to address the issues raised by the case at hand.

Obviously the courts are aware of the availability of injunctive relief. However, I am suggesting that they might do well to embrace it as the best option—superior to the competing extremes of ruinous damages and excessive deference. Over time, courts could find the right balance to make injunctive relief work effectively.

Even without damages or injunctions, declaratory relief could serve a similar purpose. A clear statement that directors have breached their fiduciary duties could help to shape the law and guide future directors, where dismissing the case for lack of a remedy would not.[39] Consider, once again, the executive compensation example. Dismissal of the case would suggest to directors—those involved as well as all others—that there was no problem. The conduct would be likely to recur. A declaratory judgment, on the other hand, would make it clear that there was a problem. This would give all directors guidance in making future compensation decisions, thereby protecting shareholders in the long run.[40]

My second proposal is that courts should think of equity in terms of larger issues rather than the specific facts at hand. This might seem counter-intuitive because courts have come to believe that the essence of equitable review is to assess the facts of the case for fairness.[41] And I do not mean to suggest that the facts are unimportant. However, there

38. Exculpation provisions apply only to directors, not to officers. *See* DEL. CODE ANN. tit. 8, § 102(b)(7) (West 2015).

39. Velasco, *supra* note 9, at 694.

40. There would be wrinkles that need to be ironed out. In order to get injunctions or declaratory relief when damages are not an option, for example, the courts would likely have to allow awards of attorney's fees. That would require its own cost-benefit analysis. But I hope to have shown that, whatever the costs may be, the benefits are by no means zero.

41. *See* Leo E. Strine, Jr., *The Delaware Way: How We Do Corporate Law and Some of the New Challenges*

are strong reasons for the courts to resist considering each case as being sui generis and to consider the larger implications as well.

Fundamentally, to focus on the facts will almost inevitably bias the case in favor of directors because it implicitly acknowledges that the conduct in question might be acceptable after all. For example, if a court does not reject an outrageous compensation package as outrageous, it will likely search sympathetically for a justification. Moreover, the issue will likely turn from the conduct involved to the motives of the directors—their good faith. I suggest that this will be a serious problem for the shareholders because courts are extremely reluctant to accuse directors of bad faith. This reluctance likely stems from a natural tendency to presume innocence and is buttressed by the presumption of the business judgment rule. Whatever the reason for this reluctance, it is significantly easier for a court to say to a director, "that is impermissible," than it is for it to say, "you are a bad person." To the extent that the focus is on the specific facts of the case, a judgment in favor of the shareholders is likely to require the second type of determination—and therefore is unlikely to occur. However, if the focus were to shift to the larger issues implicated by the conduct in question, shareholders could prevail based on the first type of determination.

Taken to its extreme, my argument might seem to suggest that all conflicts of interest should be prohibited. In fact, that may have been the law at one time.[42] But we have moved beyond that point—and I am not suggesting that we go back. Nevertheless, my proposal has implications for modern law. When conflicts of interest were first permitted, directors were required to prove that the conflicted transactions were entirely fair. Today, we are slowly moving away from "entire fairness" to a "range of fairness" standard.[43] My proposal suggests that this move might be unwise. Under a strict entire fairness standard, courts need not impugn the character of directors in order to hold for the shareholders. They can simply say, "given the stringent standard, you have not proven that the transaction is beyond reproach." To find for shareholders under a "range of fairness" standard, by comparison, the court must say something much closer to this: "You have overreached; the transaction is not even within the range of fairness." This is something courts will be uncomfortable doing, and we should not require it of them.

Arguably, it all boils down to the burden of proof. But what matters is not simply who bears the burden, but also what that burden is. Directors clearly bear the burden, but it is much more difficult to prove that a transaction is entirely fair than to prove that it is within the range of fairness. Moreover, if we understand the test to require that directors act in good faith, as I suggested earlier, then it will be very easy for them to prevail for the reasons discussed. Thus, the real burden will be on the shareholders, not the directors, despite what the law says as a technical matter.

We (and Europe) Face, 30 DEL. J. CORP. L. 673, 683 (2005) ("By its very nature, equitable review is situationally-specific . . . ."); William B. Chandler, III, *The Delaware Court of Chancery and Public Trust*, 6 U. SAINT. THOMAS L.J. 421, 425 (2009) ("[W]e must decide each case, and only that case, based on its own facts and circumstances."); *see also supra* note 24.

42. *See generally* Harold Marsh, Jr., *Are Directors Trustees? Conflict of Interest and Corporate Morality*, 22 BUS. LAW. 35 (1966) (discussing history of judicial treatment of director conflicts of interest).

43. *See, e.g.*, Reis v. Hazelett Strip-Casting Corp., 28 A.3d 442, 465–66 (Del. Ch. 2011) (discussing "entire fairness" as a "range of fairness" standard); *see also In re* Cox Commc'ns, Inc. S'holder Litig., 879 A.2d 604, 619 (Del. Ch. 2005) (discussing "the amorphous 'range' of financial fairness").

In short, to require the courts to conclude that directors are actually misbehaving to find a breach of fiduciary duty is inappropriate because the courts generally will be unwilling to do so. Realizing this, we should allow courts to change the inquiry somewhat. Rather than ask whether they believe that this director was dishonest, they should ask whether the situation is subject to abuse or disguised motives. In other words, we can empower the courts by allowing them to say, "no—this is a bad idea," rather than requiring them to say, "no—you are a bad person."

I do not mean to suggest that these two proposals would solve the problems I have identified—nor even that a few more like them would. My goal was to identify a serious problem, and to point in a new direction to look for a solution. The problem that I identified is that the law has gone too far in trying to guard against non-meritorious lawsuits. Corporate law depends upon fiduciary law principles, and those principles cannot be vindicated if meritorious lawsuits are never given a day in court. I do not mean to suggest that allowing more lawsuits would necessarily be better; I merely wish to suggest that barring more lawsuits is not always better, either. A cost-benefit analysis is appropriate, but the analysis should be applied in the aggregate, rather than at the level of each individual restriction. And it seems unlikely that the optimal level of enforcement is anywhere near zero. That would be incongruent with almost everything we know about human nature and law enforcement generally.

I also identified an issue that I believe is a significant part of the problem: that courts are reluctant to make business decisions, as well as hesitant to impugn the character of directors. I suggested that we might turn to solutions other than changes in substantive law to deal with these realities and made a couple of proposals that I believe would be helpful. These proposals assume that the basic intuitions of corporate law are correct, but may have been taken too far in some respects. With a little tweaking, I believe that corporate law can live up to its fiduciary law principles and thereby fulfill the promises it implicitly makes to shareholders who risk their fortunes to invest in enterprises that are run by others.

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