RETHINKING *ARONSON*: BOARD AUTHORITY AND OVERDELEGATION

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I. INTRODUCTION

Although a procedural rule, the demand requirement in derivative litigation is one of the most consequential doctrines in corporate law.[1] Its touchstone, for Delaware law, is the decision in *Aronson v. Lewis*,[2] in which the Supreme Court established a test for determining whether shareholder demand is futile and therefore unnecessary.[3] This Article contends that the *Aronson* test is flawed. Its test for demand futility, in certain circumstances, overly restricts board authority. Furthermore, it encourages rational boards to delegate more corporate decision-making to management and board committees than they would otherwise. The *Aronson* test, venerable as it is, ought to be refashioned.

Because of the demand requirement, shareholders may not independently pursue legal action on behalf of a corporation and must instead "demand" that the corporation's board of directors initiate litigation.[4] The demand requirement is a natural outgrowth of the authority

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1. *See, e.g.*, STEPHEN M. BAINBRIDGE, CORPORATION LAW AND ECONOMICS 386 (2002) ("Although the demand requirement looks like a mere procedural formality, it has evolved into the central substantive rule of derivative litigation.").

2. 473 A.2d 805 (Del. 1984).

3. At least one commentator has opined that *Aronson* is one of the two most influential Delaware corporate law cases. *See* Posting of Brett McDonnell to The Conglomerate, *Influential Corporate and Securities Law Cases*, http://www.theconglomerate.org/2008/03/influential-cor.html#comments (last visited Mar. 2, 2008).

4. *See* DEL. CT. C.P.R. 23.1 ("In a derivative action brought by one or more shareholders or members to enforce a right of a corporation or of an unincorporated association, the corporation or association having failed to enforce a right which may properly be asserted by it, the complaint shall . . . allege with particularity the efforts, if any, made by the plaintiff to obtain the action the plaintiff desires from the directors or

that corporate law vests in the board to make corporate decisions, including litigation decisions. Boards are then free, within the boundaries of their fiduciary duties, to determine whether to accept or refuse the demand. Demand is not required, though, if it would be futile to ask a board to initiate the relevant lawsuit. This futility exception allows board authority to be overridden under certain circumstances in order that fiduciary duties remain enforceable.

Aronson held that demand is futile when there is reasonable doubt that, *inter alia*, the underlying board decision was the product of a valid business judgment.[5] Throughout this Article, that underlying board decision is referred to as the "Original Decision," while a board's decision to accept or reject the demand (assuming it is made by plaintiffs) is referred to as the "Demand Decision." Although *Aronson* examines the Original Decision, it does so *not* because all bad Original Decisions are necessarily appropriate subjects for legal action by the corporation. Rather, *Aronson* looks to the merits of the Original Decision when there is reason to doubt directors' ability to make an impartial Demand Decision if the Original Decision was bad, i.e., if they might face personal liability because of the Original Decision.[6]

By asking this directorial bias question indirectly through the "valid business judgment" inquiry, *Aronson* opened a space between its principle (predicting demand futility by examining the likelihood of board partiality) and its test. This space became more than theoretical when the Delaware legislature permitted corporations to adopt exculpation clauses.[7] These clauses have been adopted by the vast majority of Delaware corporations,[8] and serve to immunize directors from personal liability for breaches of their duty of care. But exculpation has no bearing on whether an Original Decision was the product of a "valid business judgment." In duty of care cases, then, the link between demand futility's motivating principle and *Aronson*'s test is severed. Directors who face no personal liability will nevertheless be presumed incapable of judging demand fairly.

comparable authority and the reasons for the plaintiff's failure to obtain the action or for not making the effort.").

5. 473 A.2d at 814.

6. *See, e.g.*, *Aronson*, 473 A.2d at 815 (explaining the court's review process under the business judgment rule); Guttman v. Huang, 823 A.2d 492, 500 (Del. Ch. 2003) (focusing on the second prong of the *Aronson* test).

7. Delaware's exculpation statute is found at DEL. CODE ANN. tit. 8 § 102(b)(7).

8. *See* Claire A. Hill & Brett H. McDonnell, *Disney, Good Faith, and Structural Bias*, 32 J. CORP. L. 833, 837 (2007) (stating that while liability for bad faith decisions and loyalty violations cannot be waived, "personal liability for pure care violations" can be and have been waived by most corporations); Robert B. Thompson & Randall S. Thomas, *The Public and Private Faces of Derivative Suits*, 57 VAND. L. REV. 1747, 1786 (2004) ("It is very rare for a public company not to have taken advantage of this exculpation.").

Given corporate law's presumption of directorial authority over everyday corporate matters, *Aronson*'s demand futility test is puzzling. It effectively allocates authority over corporate litigation decisions to shareholders despite the fact that there is no explicit reason to distrust directorial decision-making. *Aronson* might conceivably be defended against this charge if either (1) its imposition upon directorial authority is *de minimis* or (2) there exist biases other than potential monetary liability that infect directorial decision-making. Yet both of these defenses create as many issues for Delaware law as they solve.

Moreover, *Aronson* is problematic for reasons other than its reallocation of authority within the firm. Because *Aronson* logically requires that the basis of the derivative suit be some sort of *action* by the board,[9] Delaware courts were forced to adopt a different test for fiduciary duty claims against directors based on their failures to act. The Supreme Court did so in *Rales v. Blasband* which established a test for demand futility based explicitly on a prediction of a board's ability to make an impartial Demand Decision.[10] *Rales*' direct approach, unlike *Aronson*'s, takes into account exculpation clauses and thereby allows less-involved boards to more effectively use those clauses as a shield for certain derivative claims at the demand stage. That is, the Delaware Supreme Court has adopted a non-neutral approach as between board action and board delegation. When faced with a set of decisions with a high litigation risk profile—especially risk involving the duty of care—rational boards find themselves better off, from a demand futility perspective, delegating the matters to board committees or employees, thereby avoiding the problems associated with *Aronson*'s failure to take exculpation clauses into account.

Part II of this Article describes the demand requirement and its theoretical foundations. Part III describes the different tests for demand futility under *Aronson* and *Rales*. It shows how *Aronson* improperly restricts board discretion in light of ubiquitous due care exculpation. Part IV observes that this aspect of *Aronson*, in combination with *Rales*, should lead rational boards to take a more passive role than they otherwise might in managing corporations under certain relatively common circumstances. By doing so, they would fall within the *Rales* line of cases and demand will turn solely on the probability of directors' personal liability in a derivative suit. By taking a more active managerial role, they would be vulnerable under *Aronson even if the directors face no likelihood of personal liability*.

9. *See Aronson*, 473 A.2d at 813 ("[I]t should be noted that the business judgment rule operates only in the context of director action. Technically speaking, it has no role where directors have either abdicated their functions, or absent a conscious decision, failed to act.").

10. Rales v. Blasband, 634 A.2d 927, 934 (Del. 1993).

Part V anticipates two objections—one solely to the overdelegation argument and the other to both the overdelegation and board authority arguments. First, it may be that recent Delaware case law regarding directors' duty of good faith makes board inaction less likely to be exculpable under a 102(b)(7) charter provision. If so, boards would have little incentive to overdelegate because the *Rales* test turns out poorly for them if they face a substantial likelihood of personal liability for breach of good faith. But this argument places far too much weight on the doctrine of good faith and should give rational boards little reason to discount the litigation-related advantages of delegation. Second, it may be that whatever odd implications are created by *Aronson* at the demand stage, they are of no real import because exculpation clauses can be enforced through a contemporaneous motion to dismiss. This objection, however, fails to take into account (1) the different evidentiary standards applicable to motions to dismiss for failure to make demand and 12(b)(6) motions to dismiss based on an exculpatory clause and (2) the characterization of an exculpatory clause as an affirmative defense. Part VI observes that the *Aronson* and *Rales* tests need to be harmonized and concludes that, despite *Rales*'s potential for underestimating directors' biases, the *Aronson* test should be revised to reflect *Rales*'s more direct approach.

II. THE DEMAND REQUIREMENT AND DEMAND FUTILITY

A. *Boards, Shareholders and Derivative Suits*

1. Board Authority

The Delaware General Corporate Law allocates authority over a corporation's everyday decision-making to the board of directors except as otherwise provided by law or charter provisions.[11] The *Aronson* court observed that Section 141(a) establishes "[a] cardinal precept of the [law] . . . is that directors, rather than shareholders, manage the business and affairs of the corporation."[12] As a descriptive matter, it is certainly the case that corporate law places control of the day-to-day operations of a corporation in the hands of a board as opposed to the hands of shareholders.[13]

11. DEL. CODE ANN. tit. 8 § 141(a).
12. *Aronson*, 473 A.2d at 811.
13. Lynn Stout has noted that, in fact, a surprisingly small number of Delaware firms opt out of director control as allowed by the last clause of § 141(a). *See* Lynn A. Stout, *The Shareholder as Ulysses: Some Empirical Evidence on Why Investors in Public Corporations Tolerate Board Governance*, 152 U. PA. L. REV. 667, 669 (2003).

The normative basis for directors' authority is the matter of some debate,[14] as are the circumstances in which that authority ought to be transferred to or shared with other constituencies, particularly shareholders.[15] There is consensus, however, that corporations realize significant gains through the allocation of everyday decision-making authority to a small group of actors. If authority were spread over a wide group (say, public shareholders), significant collective action problems would arise. Diffuse decision-makers are likely to be rationally apathetic towards the decision-making process as they recognize that they have little ability to affect the outcome and will only realize a fraction of the consequences of any particular decision.[16] To the extent they do participate, they would likely be poorly informed relative to insiders.[17] Moreover, the diffuse decision-makers might have significantly different interests, some of which may conflict.[18] And, of course, corporate decision-making by thousands of participants would be incredibly unwieldy and slow.[19] On the other hand, if authority is vested in a small body that is perceived as relatively neutral and consistent, it may encourage other constituencies to make otherwise risky firm-specific investments.[20] All of this counsels for vesting day-to-day operating authority in a small,

14. *See, e.g.*, Stephen M. Bainbridge, *Director Primacy and Shareholder Disempowerment*, 119 HARV. L. REV. 1735 (2006) (arguing against Lucian Bebchuk's proposal for shareholder empowerment and for the preservation of the current regime of limited shareholder voting rights); Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247 (1999) (opposing the dominant principal-agent model of the public corporation driven by the goal of shareholder wealth maximization).

15. Suffice it to say that the appropriate outer bounds of board authority vis-a-vis shareholder authority are a topic about which a significant amount of academic and judicial ink has been spilled. For a taste of the debate in regard to shareholder voting, see Lucian A. Bebchuk, *The Myth of the Shareholder Franchise*, 93 VA. L. REV. 675 (2007) (hereinafter Bebchuk, *Shareholder Franchise*); Martin Lipton & William Savitt, *The Many Myths of Lucian Bebchuk*, 93 VA. L. REV. 733 (2007); Jonathan R. Macey, *Too Many Notes and Not Enough Votes: Lucian Bebchuk and Emperor Joseph II Kvetch About Contested Director Elections and Mozart's Seraglio*, 93 VA. L. REV. 759 (2007); John F. Olson, *Professor Bebchuk's Brave New World: A Reply to "The Myth of the Shareholder Franchise"*, 93 VA. L. REV. 773 (2007); Lynn A. Stout, *The Mythical Benefit of Shareholder Control*, 93 VA. L. REV. 789 (2007); E. Norman Veasey, *The Shareholder Franchise is Not a Myth: A Response to Professor Bebchuk*, 93 VA. L. REV. 811 (2007).

16. *See, e.g.*, Stout, *supra* note 15, at 792.

17. *See, e.g.*, *id.*

18. *See, e.g.*, *id.*, at 794-95. For more information, see Ashwini K. Agrawal, *Corporate Governance Objectives of Labor Union Shareholders: Evidence from Proxy Voting* (N.Y.U., Stern Sch. of Bus., 2008), *available at* http://home.uchicago.edu/~aagrawa1/AGRAWAL_paper.pdf (demonstrating that union shareholders are less likely to support director nominees at corporations at which the union's members are employed).

19. *See, e.g.*, Stout, *supra* note 15, at 792.

20. *Id.* at 795-97.

relatively well-informed and presumptively neutral group.[21]

Corporate litigation decisions are subsumed within this day-to-day operating authority.[22] As an example, assume that a counterparty to a contract with Corporation X fails to provide services or deliver goods as promised. Corporation X has the ability to go to court and enforce the contract. Whether Corporation X will litigate, however, is up to the board (or its delegate). After all, not all potential actions that a corporation may institute are necessarily worth pursuing. The board may choose not to file a suit because, for instance, the litigation costs are too high relative to the amount in question or the litigation would threaten to distract management from running the corporation.

2. Derivative Suits

What can shareholders do if they believe the board's litigation decision reduces firm value—say by failing to pursue a valuable claim against the counterparty? The classic response is that shareholders can vote (for new directors), sell (their stock to other investors) or sue (directors for breach of fiduciary duty).[23] Continuing the above example, the third option is accomplished through a derivative suit whereby the shareholder sues on behalf of the corporation contending (1) that the corporation ought to have sued the director for a breach of fiduciary duty in making a bad decision, and (2) because it failed to do so, the shareholder would like to step into the corporation's shoes and proceed with the litigation on the corporation's behalf.[24]

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21. Theoretically, this smaller group could be a unitary executive rather than a board. *But see* Stephen M. Bainbridge, *Why a Board? Group Decision-making in Corporate Governance*, 55 VAND. L. REV. 1 (2002) (noting the decision-making improvements gained by having a small group of decision-makers). Note that this justification for board authority explicitly avoids application to authority outside the scope of day-to-day operating authority. Some commentators have argued that board authority is problematic in respect of a certain class of "rules-of-the-game decisions." *See* Lucian A. Bebchuk, *Letting Shareholders Set the Rules*, 119 HARV. L. REV. 1784 (2006); Lucian A. Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833 (2005). Others have argued that even in those cases, the advantages of board authority may outweigh any disadvantages. *See* Bainbridge, *supra* note 14; Leo E. Strine, Jr., *Toward a True Corporate Republic: A Traditionalist's Response to Bebchuk's Solution for Improving Corporate America*, 119 HARV. L. REV. 1759 (2006).

22. *See, e.g.*, Spiegel v. Buntrock, 571 A.2d 767, 772-73 (Del. 1990); Bradley T. Ferrell, *A Hybrid Approach: Integrating the Delaware and the ALI Approaches to Shareholder Derivative Litigation*, 60 OHIO ST. L.J. 241, 248 (1999).

23. *See, e.g.*, MICHAEL P. DOOLEY, FUNDAMENTALS OF CORPORATION LAW 483 (1995); Robert B. Thompson, *Shareholders as Grown-Ups: Voting, Selling and Limits on the Board's Power to "Just Say No,"* 67 U. CIN. L. REV 999, 1000-01 (1999) (introducing shareholder power to respond to actions of directors).

24. *See* David A. Skeel, *The Accidental Elegance of Aronson v. Lewis* 3 (U of Penn,

Derivative suits thus represent an important avenue by which shareholders can minimize agency costs that arise in widely-held corporations. In the earlier hypothetical, directors may obtain benefits by not suing the counterparty, such as avoiding the hassle of being deposed, avoiding a reputation as a litigious person, or even receiving a bribe. Moreover, they may undervalue the recovery to be obtained by the corporation because they are unlikely to receive much, if any, of the benefit from the judgment.[25]

Leaving the contract hypothetical aside, take perhaps the most obvious example of the diverging interests of shareholders and managers—theft of corporate property or cash by the managers. Shareholders cannot sue the thief directors directly because the harm was incurred by the corporation and not directly by the shareholders. Because the claim belongs to the corporation, it must initiate the litigation. However, in this case, the thieves have the authority to decide whether or not the company should sue.[26] Because they will, at the very least, be forced to reimburse the corporation, the directors cannot be expected to direct the corporation to bring a lawsuit. Shareholders who want the corporation to pursue litigation against the directors can attempt to force the corporation to do so through a derivative suit.

Derivative suits, however, pose a problem for the initial allocation of authority within the corporation. It is easy to see that the power to sue derivatively could very well swallow up the litigation-related authority that boards are granted under Section 141(a).[27] What if it is not certain either that the theft occurred or that, assuming something improper did happen, a lawsuit to recover the stolen money is in the firm's best interests? For Section 141(a) to be effective, then, boards need to be protected to a certain degree from derivative suits.[28]

Inst for Law & Econ, Research Paper No. 07-28, 2007), *available at* http://ssrn.com/abstract=1027010 (detailing the history of the derivative suit).

25. *See* Jeffrey N. Gordon, *Independent Directors and Stock Market Prices: The New Corporate Governance Paradigm* 23 (Columbia Law & Econ., Working Paper No. 301, 2006), *available at* http://ssrn.com/abstract=928100 (discussing potential incentives for outside directors to engage in good performance).

26. *See, e.g.*, Bebchuk, *Shareholder Franchise*, *supra* note 15, at 679-82 (discussing role of shareholders).

27. *See Aronson*, 473 A. 2d at 811 ("By its very nature the derivative action impinges on the managerial freedom of directors.").

28. *But see* John C. Coffee, Jr. & Donald E. Schwartz, *The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform*, 81 COLUM. L. REV. 261, 262 (1981) (explaining how courts have upheld directors' ability to avoid derivative suits).

B. The Demand Requirement

This protection is given effect, to a large extent, by the substantive rules of fiduciary obligations. The business judgment rule[29] limits the number of triable fiduciary claims.[30] In the breach-of-contract example, the board chose not to sue the counterparty. The failure to sue will mean that the corporation will not realize any damages or settlement from the counterparty. If shareholders sue derivatively, the business judgment rule, assuming it has not been rebutted, acts to protect the board even if a judge or jury might ultimately agree with the shareholders as to the merits of the decision not to litigate.

The business judgment rule might prevent many incursions by shareholders into board decision-making via the derivative suit. However, the business judgment rule functions as a device *within* litigation. Necessarily, a board (and therefore a corporation) will incur costs to convince a court that the business judgment rule ought to protect the board's Original Decision. Those costs were imposed because a single shareholder decided to file a derivative suit. Put another way, from the time at which the shareholder sues derivatively until the time at which the suit is dismissed, Section 141(a)'s allocation of authority has been turned on its head. The derivative suit, even if ultimately unsuccessful, is at least for a fleeting (or not-so-fleeting) moment a threat to the board's authority over the litigation decision itself.

Moreover, to the extent that application of the business judgment rule is uncertain, there are significant incentives for the board to settle *all* litigation.[31] The vast majority of companies purchase policies insuring both directors against liability risk and the companies themselves for reimbursements paid to directors under indemnification agreements.[32] Given the limitations placed on director indemnification in adjudicated suits,[33] directors face a small but existent probability of a large loss. For

29. *Aronson*, 473 A.2d at 812 (establishing 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")

30. *Id.* ("The business judgment rule is an acknowledgment of the managerial prerogatives of Delaware directors under Section 141(a).").

31. *See* DOOLEY, *supra* note 23, at 304-05.

32. *See* Sean J. Griffith, *Uncovering a Gatekeeper: Why the SEC Should Mandate Disclosure of Details Concerning Directors' and Officers' Liability Insurance Policies*, 154 U. PA. L. REV. 1147, 1168 (2006) (citations omitted) (noting a survey indicating that 99% of U.S. company respondents had purchased D&O policies in 2004).

33. *See* DEL. CODE ANN. tit. 8, §145(b) (2006) (requiring certification that the director "acted in good faith and in a manner the person reasonably believed to be in or not opposed to the best interests of the corporation" as well as an additional judicial determination, in the event of liability, that the director "is fairly and reasonably entitled to indemnity" for "proper" expenses).

directors, then, the decision to settle even meritless suits is almost costless, save for potentially increased insurance premia which will, in any event, be passed on to the corporation.

The demand requirement is corporate law's answer to these problems. Under the Delaware Chancery Court rules, a shareholder must make a demand on the board requesting that it cause the corporation to sue whomever it is that the shareholder believes ought to be sued.[34] The demand requirement, insofar as it gives the board the power to say "no" to a derivative suit, preserves the original allocation of authority to the board.[35]

The demand requirement serves other salutary purposes as well. First, the demand requirement promotes judicial efficiency by keeping fights inside boardrooms and outside of courtrooms.[36] Alternative dispute resolution has become extremely popular as a way to take some of the pressure off of overburdened courts.[37] Delaware's demand requirement establishes a system of extrajudicial dispute resolution that may allow the Chancery Court to devote more time to matters not otherwise susceptible to alternative resolution.[38]

Similar but distinct from its effect on the allocation of authority within a firm, the demand requirement serves as a filter for frivolous suits.[39] As noted above, there are significant incentives for directors to settle even non-meritorious derivative suits. Plaintiffs' attorneys are aware of these incentives and are likely to file even non-meritorious suits.[40] The demand requirement, to the extent it provides boards with an early crack at dismissing the action or handing it over to the board, removes some of the incentive for plaintiffs' attorneys to bring frivolous cases.

The demand requirement serves its function well for as long as the interests of the board in regard to the Demand Decision do not diverge

34. Subject to claims of demand futility or wrongful refusal discussed *infra* Part III. *See* DEL. CT. C.P.R. 23.1. (specifying the statutory demand requirement).

35. *See, e.g.*, *Guttman*, 823 A.2d at 500.

36. *See* Brehm v. Eisner, 746 A.2d 244, 255 (Del. 2000) (explaining how the demand requirement can be used to avoid litigation).

37. *See, e.g.*, Paul R. Verkuil, *Privatizing Due Process*, 57 ADMIN. L. REV. 963, 983 (2005) (defining alternative dispute resolution as a source of private due process); Charles Silver, *Does Civil Justice Cost Too Much?*, 80 TEX. L. REV. 2073, 2104-05 (2002) (explaining how alternative dispute resolution saves money).

38. *See, e.g.*, Ferrell, *supra* note 22, at 248 and n. 26 (explaining the potential for intra-corporate resolution as a rationale for the demand requirement).

39. *See Aronson*, 473 A.2d at 811-12.

40. *See, e.g.,* Mark J. Loewenstein, *Shareholder Derivative Litigation and Corporate Governance*, 24 DEL. J. CORP. L. 1, 25-26 (1999) (showing how settlement incentives may be exacerbated by the rules surrounding plaintiff's attorney's fees in derivative litigation); Roberta Romano, *The Shareholder Suit: Litigation Without Foundation?*, 7 J.L. ECON & ORG. 55, 65 (1991) (same).

from those of shareholders. Imagine that the "demanded" litigation has, as a named defendant, a board member. In fact, most derivative suits are attempts to force the corporation to sue an insider, not a counterparty to a contract or a third party tortfeasor.[41] Can we trust directors to sue themselves or other directors when appropriate? If we cannot, the demand requirement may allocate too much authority to the board at the expense of the enforcement of directors' fiduciary duties. There can be such a thing as too much protection of directorial prerogative—after all, even the business judgment rule can be rebutted. Without a way around the demand requirement in cases where directors are disabled from independently making a Demand Decision, directors' fiduciary duties would be rendered unenforceable and directors may systematically engage in value-destroying activity.

III. THE DEMAND FUTILITY TESTS: ARONSON AND RALES

Shareholders do have ways to get around the demand requirement. First, they can proceed with a derivative suit without making a demand on the board if demand would have otherwise been futile.[42] Second, if they make demand and the board "wrongfully" refuses the demand, shareholders can proceed with the lawsuit.[43] Demand futility, however, is by far the most popular of these two routes for shareholder-plaintiffs.[44] Indeed, demand futility has been called "*the* critical issue in derivative litigation."[45]

41. *See* Skeel, *supra* note 24, at 3.

42. There is some dispute as to whether a futility exception ought to exist or whether issues of futility would be better off being raised in a wrongful refusal action. *See* Kamen v. Kemper Finan. Servs., Inc., 908 F.2d 1338, 1344 (7th Cir. 1990), *rev'd* 500 U.S. 90 (1991) (adopting a universal demand requirement); Michael P. Dooley, *Two Models of Corporate Governance*, 47 BUS. LAW. 461, 502-03 (1992) (criticizing universal demand); Jeffrey S. Facter, *Fashioning a Coherent Demand Rule for Derivative Litigation in California*, 40 SANTA CLARA L. REV. 379, 379 (2000) (proposing that California adopt a universal demand rule).

43. *See, e.g.,* Grimes v. Donald, 673 A.2d 1207, 1217-19 (Del. 1996), *overruled on other grounds*; *Brehm,* 746 A.2d 244.

44. The general consensus is that it is almost impossible for shareholder plaintiffs to prevail in a "wrongful refusal" action. *See, e.g.*, Randall S. Thomas & Kenneth J. Martin, *Litigating Challenges to Executive Pay: An Exercise in Futility?*, 79 WASH U. L. Q. 569, 576-77 (2001); Thompson & Thomas, *supra* note 8, at 1782 (examining data showing that in most cases demand is not made on the board of directors).

45. Stephen Bainbridge, *The Demand Requirement in Derivative Litigation: Part II*, http://www.businessassociationsblog.com/lawandbusiness/comments/the_demand_requirement_in_derivative_litigation_part_ii/ (emphasis added).

A. *Aronson*

Perhaps surprisingly, the general test for demand futility in Delaware has remained constant for over 20 years.[46] In *Aronson*, the Delaware Supreme Court held that demand is futile when "under the particularized facts alleged, a reasonable doubt is created that: (1) the directors are disinterested and independent, and (2) the challenged transaction was otherwise the product of a valid exercise of business judgment."[47] The two prongs are intended to track the business judgment rule; in fact, the second prong consists solely of a reference to the rule.[48] The *Aronson* court drove the point home, noting that demand futility "is *inextricably bound* to issues of business judgment and the standards of that doctrine's applicability."[49]

Why should demand futility be inextricably bound with the business judgment rule? The business judgment rule might be a logical jumping-off point for evaluating a Demand Decision, just as it is the standard for evaluating most board decisions. But the *Aronson* test—especially its second prong—does not directly apply the business judgment rule (even prospectively) to the Demand Decision. Instead, it focuses its analysis on the Original Decision, the "challenged transaction."

It is not clear why demand futility should have anything to do with the Original Decision. Demand futility is necessarily a predictive statement about the Demand Decision. Shareholder plaintiffs have to argue that it would make no difference—it would be futile—to ask the board to make the Demand Decision. It would make no difference because it is obvious, for some reason or another, that the board will reject demand. Absent some link between (1) the nature of the Original Decision and (2) our expectation of how the board will make a Demand Decision, the Original Decision is more or less beside the point for demand futility purposes.

The lack of a necessary nexus between the quality of the Original Decision and the futility of demand assumes that the primary reason to require demand is to protect board authority. As discussed above, the

46. *See* Joshua L. Vineyard, *The More Things Change, the More They Stay the Same? Twenty Years of Corporate Board Domination and the Aronson v. Lewis Standard*, 72 U. CIN. L. REV. 1067, 1068 (2004) (demonstrating the pervasive use of the *Aronson* standard).

47. *See Aronson*, 473 A.2d at 814. For some period following the court's decision in *Aronson* there was doubt as to whether the two prongs of the *Aronson* test were to be viewed in the conjunctive or the disjunctive. The debate was ended in favor of the latter. *See* Levine v. Smith, 591 A.2d 194, 206 (Del. 1991).

48. It is often noted that the second prong imports the business judgment rule into the demand futility decision. But the questions of disinterestedness are themselves foundational questions in any business judgment analysis. *See, e.g.*, DOOLEY, *supra* note 42, at 471-77. To the extent a director is interested in a challenged transaction, he or she will not receive protection of the business judgment rule. *Id.*

49. *Aronson*, 473 A.2d at 812 (emphasis added).

argument for board authority over litigation decisions begins with the observation that whether a lawsuit is in the corporation's best interests turns on a number of factors in addition to the merits of the claim, such as litigation costs (if the case is a close call requiring substantial litigation), reputational harm, and the potential for management distraction. These are extra-legal issues about which the courts may have little institutional competence.[50] The business judgment rule is justified in large part by the view that boards are better than courts at making business decisions like these. Absent other considerations, boards should decide such matters and shareholders are generally better off if particular shareholders cannot initiate litigation without the board's approval.

However, in addition to protecting board authority, the demand requirement also serves to filter out strike suits.[51] That function necessarily involves review of the Original Decision because the quality of the Original Decision is crucial to determining whether or not the derivative suit is a "strike" suit or a legitimate one. Thus, even if there were no reason to believe that boards ought to have any authority to decide when derivative suits ought to proceed, the potential for frivolous derivative suits poses a problem for firm value.[52] Quite apart from any concerns about the advantages of board authority, a prophylactic device might be needed to separate the good derivative suits from the bad ones.

Considering the centrality of board authority to corporate governance generally, how important of an argument for requiring demand is "demand as strike suit filter"? One gets something of an answer by reading Vice Chancellor Strine's opinion in *Guttman v. Huang*:

> If the legal rule was that demand was excused whenever, by mere notice pleading, the plaintiffs could state a breach of fiduciary duty claim against a majority of the board, the demand requirement of the law would be weakened *and the settlement value of so-called "strike suits" would greatly increase*, to the perceived detriment of the best interests of stockholders as investors. But, if the demand excusal test is too stringent, then stockholders may suffer as a class because the deterrence effects of meritorious derivative suits on faithless conduct may be too weak. The second prong of *Aronson* therefore balances the conflicting policy interests at stake by articulating a safety valve that releases a suit for prosecution when the complaint meets a heightened pleading standard of particularity, *because in these*

50. *See Zapata v. Maldonado,* 430 A.2d 779, 788 (Del. 1981) ("[W]e recognize that (t)he final substantive judgment whether a particular lawsuit should be maintained requires a balance of many factors ethical, commercial, promotional, public relations, employee relations, fiscal as well as legal.") (quotations omitted).

51. *See* Ryan v. Gifford*,* 918 A.2d 341, 352 (Del. Ch. 2007) ; *Brehm*, 746 A.2d at 255.

52. *See supra* notes 31-33 and accompanying text.

> *circumstances the threat of liability to the directors required to act on the demand is sufficiently substantial to cast a reasonable doubt over their impartiality*.[53]

On the one hand, the demand requirement serves the distinct function of strike suit filter. On the other hand, demand futility is about board authority and the need to depart therefrom only when its benefits are outweighed by a systematic inability to hold fiduciaries responsible for breaches of their duties. Filtering for strike suits is one benefit of granting a board significant discretion, but it is not the only one. For example, even if a claim is meritorious, there may be other reasons to not pursue litigation. Why do courts talk so much about strike suits? Because limiting them is the *largest, but not sole,* benefit provided by the demand requirement's return of authority to the board.

The second prong's implicit adoption of "demand as strike suit filter" allows courts to avoid thorny problems raised by board authority over derivative litigation. In this regard, there is a fairly uncontroversial starting point: directors with financial interests in the outcome of Demand Decisions (or who are beholden to people with such interests) should not be trusted to make them in the best interests of the corporation. But what if boards' Demand Decisions are consistently problematic outside of this admittedly limited set of cases? For instance, directors may simply be embarrassed by their past conduct (or past omissions) and may seek to quash a derivative suit to avoid the reputational harm a lawsuit might cause.[54] Alternatively, bounded rationality and/or structural biases may prevent even the least interested or embarrassed directors from judging demand fairly by making it difficult if not impossible for directors to either come to grips with the harm they have caused the corporation or take action to rectify the situation.[55]

If true—and it has at least some anecdotal support considering the paucity of demand acceptances—this view would lead to the conclusion that demand is, in fact, almost always futile. Adopting such a position—call it something like the "strong bias" view—should probably lead to the rechristening of whatever test is adopted. The operative question would not be whether demand is futile because it would *always* be futile. Rather, any preliminary test would simply enable a court to weed out frivolous suits.

The problems created by taking this position are thorny because there are, of course, costs in asking only whether a complaint satisfies some

53. Guttman v. Huang, 823 A.2d 492, 500 (Del. Ch. 2003) (emphasis added).

54. It is not clear what marginal reputational harm is caused by allowing a suit to proceed once a complaint (no matter how "blocked" it may ultimately be by the demand requirement or an exculpation clause) is filed and presumably made public.

55. *See e.g.*, *Guttman*, 823 A.2d at 500.

minimum threshold of viability. Cutting boards out of the action means that they can no longer evaluate the extra-legal considerations concerning a derivative suit's value to a corporation. A test that assumes all demand is futile and serves solely as a filter for strike-suits would then likely fail to stop suits that—while potentially meritorious—are not in the shareholders' best interests, all things considered. Courts could be required to take the extra-legal considerations into account—think of a *Zapata*-style analysis for all derivative suits—but we cannot be sure that courts will do a great job of evaluating such considerations.[56]

Moreover, the strong bias view is a fairly blunt instrument. The problem with embarrassment or bounded rationality or structural bias, unlike financial interest, is that it is hard to prove. To create a workable framework, corporate law will likely have to assume either (1) these states of mind *always* exist for *all* boards or (2) *never* exist for *any* board. While admittedly a not-uncontroversial description of the way boards actually operate, the latter assumption seems at least to comport with Delaware jurisprudence's most basic foundation.[57]

Unless one adopts the strong bias view, the demand requirement must be premised primarily on the need to protect board authority. The *Aronson* opinion itself supports this approach. For instance the Supreme Court stated that demand futility is intended to capture the instances in which a board "is under an influence which sterilizes [its] discretion [as to whether to proceed with the suit in question]."[58] If that is to be the question, any test for demand futility needs to focus primarily on the putative Demand Decision, not the Original Decision.

But then why do *Aronson*'s prongs turn on the quality of the Original Decision? The Original Decision may be important in balancing board authority with enforcement of fiduciary duties.[59] Directors who were financially interested in the Original Decision will likely be financially interested in the Demand Decision. Those dominated by parties who were interested in the Original Decision are likely to be similarly dominated by those who are interested in the Demand Decision. Thus, the first *Aronson* prong, which can look backwards to the Original Decision, serves as a sensible proxy for determining whether the board is capable of being disinterested and independent in making a Demand Decision.

56. *But see* Hill & McDonnell *supra* note 8, at 855 (suggesting that courts evaluate the level of structural bias present in board decision-making). For criticism of *Zapata* on this point, see e.g., Julian Velasco, *Structural Bias and the Need for Substantive Review*, 82 WASH. U. L. Q. 821, 850 (2004) and accompanying footnotes.

57. *See infra* note 86 and accompanying text (describing post-*Rales* cases establishing that an exculpation clause removes any concern as to a director's ability to make an independent demand decision).

58. *Aronson*, 473 A.2d at 814.

59. *See Harris v. Carter*, 582 A.2d 222, 230 (Del. Ch. 1990).

Likewise, the second *Aronson* prong, which looks strictly backwards to the Original Decision, serves as a proxy of sorts. As mentioned earlier, to the extent that the Original Decision was not the subject of a valid business judgment, the business judgment rule would not apply in a derivative suit and directors could potentially be personally liable for damages. In such cases we ought to be skeptical of directors' ability to rise above their financial interest in not being sued.[60] The second *Aronson* prong thus stands in as a substitute for a certain kind of director interest at the demand stage.[61]

The following illustrates the ways in which the Original Decision and the Demand Decision are distinct bases for judging demand futility. The first *Aronson* prong involves questions of director disinterest and independence. Take the following example: Company X has a seven-member board of directors. Company Y serves as a supplier for Company X. Six months earlier, Company X's board met to discuss a new agreement with Company Y. Company X's directors voted to enter into an agreement with Company Y under which Company Y would deliver supplies to Company X at a price significantly higher than the market rate for such supplies. Now imagine that shareholders discover that the seven Company X directors were the sole shareholders of Company Y. If Company X shareholders demand that Company X sue the directors for breaching their duty of loyalty, demand will be excused under the first *Aronson* prong.[62] Note that the analysis is focused on the Original Decision rather than the Demand Decision.

What if only three of Company X's directors had been the sole shareholders of Company Y, but one of those three was the CEO of Company X. Assume further that two of the other four directors of Company X were employees of Company X subject to being fired by the CEO/director. In that case there may be a reasonable doubt that, with respect to the decision to award Company Y the contract, the three directors were disinterested and the other two were independent.[63]

60. One might sensibly ask whether there is even a cognizable interest in that case, given directors' insurance.

61. It is perhaps worth also noting that the second prong may be superfluous. If the first *Aronson* prong (disinterestedness and independence) was read broadly to look both back to the Original Decision as well as prospectively to the Demand Decision, it could easily capture this fear-of-liability point.

62. *See Aronson*, 473 A.2d at 815 ("Certainly, if this is an 'interested' director transaction, such that the business judgment rule is inapplicable to the board majority approving the transaction, then the inquiry ceases."); *see also* Pogostin v. Rice, 480 A.2d 619, 624 (Del. 1984), *overruled on other grounds*; Brehm v. Eisner, 746 A.2d 244 (Del. 2000).

63. *See Aronson*, 473 A.2d at 816 ("Independence means that a director's decision is based on the corporate merits of the subject before the board rather than extraneous considerations or influences. . . . [However, W]e conclude that in the demand-futile context

Demand would be excused. Again, disinterest and independence are measured by reference to the Original Decision.

This need not be the case, however. Taking the hypothetical further, what if the three Company X directors were interested in the contract at the time of the Original Decision but none of the other four directors were employees of Company X?[64] Absent any other facts, a majority of the board was disinterested and independent in regard to the Original Decision. Assume that, sometime after the Original Decision, one or more of the non-interested, independent directors became employees of Company X, subject to control by the interested CEO/director. Now, such an employee/director would likely not be independent with respect to the Demand Decision. In such cases, demand would surely be futile under the first prong of *Aronson*, notwithstanding the fact that there was no reasonable doubt that the majority of directors, when making the Original Decision, was disinterested or independent.[65] Thus, the first *Aronson* prong seems to be applicable to either the Original Decision or the Demand Decision.

The second *Aronson* prong, on the other hand, is very clearly limited to review of the Original Decision.[66] Continuing the hypothetical from above, assume three interested Company X directors and four disinterested and independent directors both at the time of the Original Decision and at the time of the Demand Decision. Assume further, however, that either (a)

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a plaintiff charging domination and control of one or more directors must allege particularized facts manifesting 'a direction of corporate conduct in such a way as to comport with the wishes or interests of the corporation (or persons) doing the controlling.'")

64. Assume that the approval of the contract with Company Y was not approved by disinterested directors pursuant to DEL. CODE ANN. tit. 8 §141(a)(1) because, for instance, three of the four disinterested directors rejected the deal.

65. *See, e.g.*, *Rales*, 634 A.2d at 936 ("To establish lack of independence, [plaintiff] must show that the directors are 'beholden' to the [interested defendants] or so under their influence that their discretion would be sterilized.").

66. *See Aronson*, 473 A.2d at 814 ("Hence, the Court of Chancery must [inquire] . . . into the substantive nature of the *challenged transaction* and the board's approval thereof.") (emphasis added). Conceptually, one could imagine that the second *Aronson* prong applied to the Demand Decision is roughly the wrongful refusal analysis. The "wrongfulness" of the refusal is determined via application of the business judgment rule. *See, e.g.*, Grimes v. Donald, 673 A.2d 1207, 1218-19 (Del. 1996). Accordingly, the shareholder claiming wrongful refusal must "allege facts with particularity creating a reasonable doubt that the board. . . acted independently or with due care in responding to the demand." *Id.* at 1219. Other iterations of the wrongful refusal standard require allegations that "directors [did not act] in an informed manner [or] with due care [or] in a good faith belief that their action was in the best interest of the corporation." Levine v. Smith, 591 A.2d 194, 198 (Del. 1991). Any potential conflict between the two standards was apparently resolved in Scattered Corp. v. Chicago Stock Exchange, Inc., 701 A.2d 70 (Del. 1997). There, the Delaware Supreme Court held that "[f]ailure of an otherwise independent-appearing board or committee to act independently is a failure to carry out its fiduciary duties in good faith or to conduct a reasonable investigation." 701 A.2d at 75.

the disinterested directors who voted in favor of the deal with Company Y failed to consider all reasonably available material information,[67] or (b) the transaction with Company Y was so egregiously one-sided as to be irrational or waste.[68] *Aronson*'s second prong is satisfied by looking at the procedural and perhaps substantive quality of the Original Decision.[69] In this case, demand would be futile because the Original Decision would not be entitled to the presumption of the business judgment rule. Expectations about the procedure and/or substance of the board's putative Demand Decision are excluded.

Aronson's second prong makes sense as a proxy for a certain kind of director interest—fear of personal liability. And a helpful proxy it is, as long as directors are potentially liable for Original Decisions that were not the subject of a valid business judgment. That was true at the time *Aronson* was decided but is not necessarily so since the Delaware legislature permitted companies to include exculpation provisions in their certificates of incorporation.[70] Section 102(b)(7) permits companies to exculpate directors from derivative suit liability, at least to the extent they do not violate their duty of loyalty or fail to act in good faith.[71] Accordingly, the statute is generally interpreted as providing protection to directors for breaches of their duty of care.[72]

If directors are protected from liability for breaches of the duty of care, it will be difficult to prove that their discretion would be "sterilized" when making a Demand Decision.[73] Without the specter of personal

67. *See, e.g.*, Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985) (holding that the determination of whether business judgment of board of directors is informed turns on whether directors have informed themselves, prior to making business decision, of all material information reasonably available to them).

68. *See Brehm*, 746 A.2d at 266 (stating that alleging waste requires pleading "particular facts tending to show that no reasonable business person would have made the [same] decision . . . under these circumstances").

69. Delaware courts have expressly rejected "substantive due care." *See, e.g.*, *Brehm*, 746 A.2d at 264. However, there is arguably a practical outer boundary, the crossing of which resembles something akin to breaching substantive due care. *See* David Rosenberg, *Galactic Stupidity and the Business Judgment Rule*, 32 J. CORP. L. 301, 321-22 (2007).

70. *See* DEL. CODE ANN. tit. 8 § 102(b)(7).

71. *See* DEL. CODE ANN. tit. 8 § 102(b)(7)(i) and (ii). Exculpation is also not available for intentional misconduct, knowing violations of the law, DEL. CODE ANN. tit. 8 § 174 violations (unlawful dividend payments, stock purchases or redemptions), or transactions through which directors receive improper personal benefits. *See* DEL. CODE ANN. tit. 8 § 102(b)(7)(ii)-(iv).

72. *See, e.g.*, John L. Reed & Matt Neiderman, *"Good Faith" and the Ability of Directors to Assert § 102(b)(7) of the Delaware General Corporation Law as a Defense to Claims Alleging Abdication, Lack of Oversight, and Similar Breaches of Fiduciary Duty*, 29 DEL. J. CORP. L. 111, 114 (2004) (citing treatises to that effect).

73. As discussed earlier, potential personal liability may not be the only basis on which directors might systematically make poor Demand Decisions. *See supra* notes 54 and accompanying text. *See also* Guttman v. Huang, 823 A.2d 492, 500 (Del. 2003).

liability hanging over their head, what else could a shareholder likely prove that would lead a court to believe that the directors could not make an independent Demand Decision? Yet *Aronson*'s second prong offers plaintiffs a non-rebuttable presumption that demand is futile anyway.[74]

The existence of exculpation clauses, then, may cause the second prong to be a less-than-perfect proxy for director interest in the Demand Decision. There are a set of cases namely duty of care cases—where the connection between (1) the lack of a valid business judgment regarding the Original Decision and (2) directors' inability to judge a demand fairly may simply not exist. As a consequence, boards are prevented from determining, for instance, that prudential considerations may counsel in favor of rejecting demand.[75] In those cases, *Aronson* fails to properly balance board authority against enforcement of fiduciary duties.

B. Rales

Non-action may provide the basis for personal liability if a director's failure to act violates his or her duty of oversight.[76] Non-action, in this sense, does not include the case in which a board considers taking a particular action and decides that continuing with the status quo is the best course of action. The decision to not act is itself considered a board action.[77] Rather, board non-action covers instances in which decisions are never the subject of deliberations by a majority of the board and are therefore not acted upon by that majority.

Historically, the duty of oversight was subsumed within the duty of

74. *See* Donald J. Wolfe & Michael A. Pittenger, *Corporate and Commercial Practice in the Delaware Court of Chancery* § 9.02 (b)(3)(iii) n. 310-312 ("*Aronson*'s second prong does not focus exclusively on the potential risk of liability of defendants arising from the underlying transaction [sic] but upon whether that transaction is one that would be entitled to the presumptions of valid business judgment. Whether the directors would or would not be exculpated from personal liability by such a charter provision would seem to have nothing to do with whether the decision itself was reached honestly and in good faith and the existence of such a provision therefore is likely to be viewed as irrelevant to *Aronson*'s second prong.") (internal citations omitted). Recently, the opinion in *In re* Lear Corp. S'holders Litig., 2008 WL 4053221, *6-7 (Del. Ch. 2008) seems to have analyzed *Aronson*'s second prong by including considerations of the applicability of an exculpation clause. Vice Chancellor Strine's move in *In re Lear* is discussed at *infra* note 210.

75. Even in the context of special litigation committee decisions which receive significantly less deference from Delaware courts than most board decisions, courts are to consider such prudential matters. *See Zapata v. Maldonado,* 430 A.2d 779, 789 (Del. 1981).

76. *See, e.g.*, Hillary A. Sale, *Monitoring Caremark's Good Faith*, 32 DEL. J. CORP. L. 719 (2007) (describing a fairly robust duty).

77. *See Aronson*, 473 A.2d at 813 ("[A] conscious decision to refrain from acting may nonetheless be a valid exercise of business judgment and enjoy the protections of the [business judgment] rule.").

care.[78] More recently, the Delaware Supreme Court has held that a claim that directors consciously disregarded known duties violates the duty of good faith, which itself sounds in the duty of loyalty.[79] Whatever the nature of the claim, directors who did not take part in corporate decisions but consciously disregarded their duties may face liability.

The potential for a duty-of-oversight derivative suit again poses a problem for balancing board authority with the need to enforce fiduciary duties. And again, the demand requirement *cum* futility exception is designed to provide the solution. But *Aronson* and its second prong cannot do any work when a derivative suit is based on the board's failure to act.[80] As discussed earlier, *Aronson* first asked whether the board can be trusted to make an unbiased Demand Decision. It then applied a once-removed test based on the applicability of the business judgment rule to the Original Decision. In cases of board non-action, however, the second *Aronson* prong will always fail because there can have been no valid business judgment regarding the board action when there was no board action.

Because *Aronson's* second prong cannot be an effective test for demand futility when the board does not act, the Delaware Supreme Court had to develop a new one. In doing so, the court simply returned to the fundamental question the *Aronson* prongs were originally intended to represent—are these directors too biased to make an independent Demand Decision?[81]

After *Rales*, Delaware courts do not apply *Aronson's* two prongs when the basis for the derivative suit involves (1) a business decision made by a board, a majority of whose members have been replaced, (2) a non-decision by the board or (3) a decision made by the board of another company.[82] In such cases, the question of demand futility turns on the generalized question of "whether [there is] a reasonable doubt that . . . the board of directors could have properly exercised its independent and disinterested

78. *See, e.g.*, *In re* Caremark Int'l Inc. Deriv. Litig., 698 A.2d 959, 960 (Del. Ch. 1996); Stephen M. Bainbridge, et al., *The Convergence of Good Faith and Oversight*, 55 UCLA L. REV. 559, 595-97 (2008).

79. *Stone v. Ritter*, 911 A.2d 362, 370 (Del. 2006). For a discussion of the relative merits of characterizing a duty-to-monitor claim as a duty of care or duty of loyalty claim, see Bainbridge et al., *supra* note 78. *See also* Claire A. Hill & Brett H. McDonnell, *Stone v. Ritter and the Expanding Duty of Loyalty*, 76 FORDHAM L. REV. 1769 (2007) (arguing that good faith claims fit along a broader continuum of fiduciary duty cases).

80. *See Aronson*, 473 A.2d at 813 ("Technically speaking [the business judgment rule] has no role where directors have either abdicated their functions, or absent a conscious decision, failed to act.").

81. *See Rales*, 634 A.2d at 934 ("[I]t is appropriate . . . to examine whether the board that would be addressing the demand can impartially consider its merits without being influenced by improper considerations.").

82. *Id.*

business judgment in responding to a demand."[83] This is essentially the first principle behind *Aronson*, but without the two-pronged test.[84]

The test established by *Rales* turns on whether the basis for the complaint "renders any of the directors 'interested' and, if so, whether any of the other directors are compromised in their ability to act independently of the interested directors."[85] Assuming disinterestedness and independence regarding the Original Decision, demand futility under *Rales* boils down to whether directors face a substantial likelihood of personal liability.[86] As in the case of board action, this likelihood of personal liability can be significantly affected by the presence of an exculpatory clause.[87] If an exculpatory clause exists in the corporation's charter, there can only be a substantial likelihood of directors' personal liability to the extent the suit involves a non-exculpated claim.[88] Accordingly, duty of care claims will not be sufficient to cast the specter of potential liability.[89] Instead, shareholders would have to allege non-exculpable claims—breaches of the duty of loyalty or good faith.[90]

Rales, by reverting back to the principle underlying *Aronson*, likely does its balancing job more simply and clearly than *Aronson*. Along this line, Chancellor Lamb has noted:

> It has been observed that [*Rales*'s] simple and straightforward inquiry would seem to be the very issue that *Aronson*, in its more mechanical and roundabout way, was intended to resolve. Moreover, because this formulation is one of general application (and can as easily be applied in the business judgment rule context addressed in *Aronson*), it is arguable that the current state of the law is conceptually inverted and that it would be both simpler and more direct to regard the original *Aronson* analysis as a subpart of the more generally applicable and flexible

83. *Id.*

84. *See Guttman*, 823 A.2d at 500 (describing the similarities between the two tests).

85. Desimone v. Barrows, 924 A.2d 908, 928 (Del. Ch. 2007).

86. *See Rales*, 634 A.2d at 936 ("In such circumstances, a director cannot be expected to exercise his or her independent business judgment without being influenced by the adverse personal consequences resulting from the decision."). Again, it may be that demand should be considered futile in cases beyond those in which a substantial threat of liability (in addition to self-interest and non-independence) is present. *See supra* notes 54 and accompanying text. Nevertheless, it appears that, at least in the *Rales* line of cases, that is not an open issue at this point.

87. *See, e.g.*, *In re* Baxter Int'l, Inc. S'holders Litig., 654 A.2d 1268, 1269-70 (Del. Ch. 1995) (noting the firm's certificate of incorporation had precluded the imposition of liability on the directors).

88. *See id.* at 1270 (explaining that the pleadings must include non-exculpated conduct).

89. *Id.*

90. *Id.*

principle set forth in *Rales*.[91]

Because it establishes a principle and is less specific than *Aronson's* prongs, the *Rales* test can adapt to the introduction of exculpatory clauses and therefore does a better job of protecting board authority over litigation decisions.

As a final point on board authority, consider the strong bias view discussed earlier. On this view, almost no board can be expected to judge a shareholder demand fairly and, therefore, any demand is futile. *Aronson's* second prong may make sense if the strong bias view prevails. Even if the strong bias view is not attractive, it may be that boards are generally incapable of fairly judging demand in respect of certain kinds of derivative suits. This is, after all, the notion behind *Aronson's* first prong and its concern for board independence and disinterest. In between these two views of board bias, one expansive and one rather limited, a third may explain the differences between *Aronson* and *Rales* as they relate to board authority. *Rales* and *Aronson* can be reconciled if boards are less likely to judge demand fairly when the derivative claim relates to past board action (keeping in mind that the board is exculpated from such claims in the relevant situation) than they are when the claim relates to something the board never did. Perhaps varying degrees of director embarrassment or a greater inability to come to terms with mistakes actively made could justify *Aronson's* second prong.

Suffice it to say that this rationalization of *Aronson's* second prong has received little attention to this point. It may very well be that their sins of commission are more troubling to directors than their sins of omission. However, as discussed below in Part IV.C, passive directors have come under increased criticism in corporate governance circles. Thus, if there is a different psychological aspect to *Rales* versus *Aronson* cases, it is certainly less pronounced than before.

IV. DEMAND FUTILITY AND OVERDELEGATION

While the *Aronson* test may be "conceptually inverted"[92] and may fail to appropriately protect board authority in certain cases, when juxtaposed with the *Rales* standard it also gives boards a reason to delegate more decisions to subordinates than it might otherwise. If *Rales* is a more director-friendly standard, then removing the board from corporate decisions will assure the most advantageous litigation posture for directors.

91. Kohls v. Duthie, 791 A.2d 772, 780-81 (Del. Ch. 2000) (internal quotations omitted).

92. *Kohls*, 791 A.2d at 781.

A. *Overdelegation*

Imagine a director of Company A. She likely has another full-time position,[93] and may even serve on other corporate boards.[94] She and her fellow directors do not have the time to make or consider every decision that Company A needs to make. Collectively, they probably do not even have the time to make or consider every *material* decision that must be made. To a large extent, they must delegate some decision-making authority to management.[95]

Nevertheless, whether out of a sense of duty, fear of personal liability for breaches of fiduciary duties, or fear of reputational damage (or some combination of all three), she would like to be involved in the decision-making process. Recent regulations push her in this direction by requiring a certain amount of her involvement in Company A's operations.[96] This active participation can involve (1) direct decision-making or (2) monitoring delegates.[97] Delegation with monitoring may itself mean delegation to management with the board monitoring management's performance or delegation to a committee of directors which may or may not further delegate to (and thereafter monitor) management.[98]

Where does she draw the line as to which classes of decisions require direct board action and which classes should be delegated? Potential liability will certainly play a role in this calculus. At the motion to dismiss stage and thereafter, directors are protected by the business judgment rule for decisions made in their managerial capacity. But, if litigation proceeds to that point, there are significant incentives for the board to settle even if

93. *See, e.g.*, Elizabeth Nowicki, *Not in Good Faith*, 60 SMU L. REV. 441, 482-84 (2007) ("Typical directors of Fortune 500 companies are usually either current officers of large businesses or former officers who are currently holding other board of consulting positions.").

94. *See, e.g.*, Abigail Aims, *2005 Trends in Corporate Governance Practices of the 100 Largest U.S. Public Companies*, 1523 PRAC. L. INST. CORP. 223, 247 (2006) (charting the number of directors of the Top 100 companies who serve on other boards).

95. *See, e.g.*, DOOLEY *supra* note 23, at 182-83 (explaining that management and policymaking are truly executive functions).

96. *See, e.g.*, NYSE, Inc., Listed Company Manual § 303A.03 (2004) and NASD Rule 4350(c)(2) (2006) (requiring independent directors to meet in regular sessions without inside directors); NYSE, Inc., Listed Company Manual § 303A.05 (2004) and NASD Rule 4350(c)(3)(A), 4350(c)(4)(A) (2006) (requiring board action in respect to compensation decisions); 15 U.S.C. § 78j-1(m), NYSE, Inc., Listed Company Manual § 303A.07(a) (2004) and NASD Rule 4350(d) (2006) (requiring action by members of the board's audit committee).

97. *See* Jill Fisch, *Taking Boards Seriously*, 19 CARDOZO L. REV. 265, 268-75 (1997) (describing the distinction between a "monitoring" board and a "managerial" board).

98. For a committee decision to qualify as a board "non-decision" and therefore qualify for *Rales* treatment, the committee must consist of less than half of the members of the board at the time demand would otherwise be required. *See Ryan*, 918 A.2d at 353.

the derivative suit has little chance for ultimate success.[99] Also, if the litigation proceeds past the motion to dismiss stage, the corporation is likely to incur significant legal costs aside from settlement costs.

As discussed above, directors are further insulated from litigation risk by the demand requirement. This should provide our director with a significant level of comfort, as long as she can be reasonably sure that demand will not be deemed futile. In addition to the significant timing advantages offered by the demand requirement, it may offer other procedural advantages (discussed in Part V.B below) for her attempts to stymie any derivative suit. Consequently, when deciding how to act as a board it should be of no small importance that demand be required, i.e. not futile, should a derivative suit challenging the corporate action (or inaction) be filed.

Under *Rales*, the relevant question for demand purposes will be whether or not there is a reasonable doubt that a majority of the board could properly exercise its independent and disinterested business judgment in responding to demand.[100] Crucially, in the case of a board delegating corporate decisions about which the directors have no personal interest and are otherwise independent-minded, the key to that question will be whether the corporation has an exculpatory clause and, if so, whether the claimed breach is exculpable.[101] If the alleged breach is covered by an exculpatory clause, demand will be required because Delaware courts recognize no cognizable interest disabling the directors from making the Demand Decision.

Contrast that result with the situation had the directors not delegated and instead made a full (or at least majority) board decision regarding the matters. Because there had been board action, demand would be judged under *Aronson*. In the case of a decision about which the directors have no personal interest and are otherwise independent-minded and where the company has an exculpatory clause that covers any claim, demand will still be potentially futile under *Aronson's* second prong if plaintiffs successfully plead a due care breach. Sufficiently pleading a duty of care claim with particularity is difficult, but not nearly impossible. Thus, if boards rely on the demand requirement to protect them from derivative litigation, delegation will be preferable to direct management in these circumstances.

One important limitation on these incentives could be the capacity of directors to otherwise effectively mitigate litigation risk. The analysis

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99. *See supra* notes 23 and accompanying text.

100. *Rales*, 634 A.2d at 934.

101. *See supra* notes 83-91 and accompanying text; *Desimone*, 924 A.2d at 935-36. Regarding exculpability, delegation may present the question of whether *Caremark* duties, and therefore the duty of good faith, have been violated. *See infra* Part V.A (discussing the *Caremark* duties in the case of delegation).

above assumes that majority board involvement cannot be expected to significantly reduce the number of decisions about which shareholders will colorably complain in duty of care derivative suits. If this were not the case—that is, if boards could by their very involvement in decision-making, greatly reduce duty of care litigation—boards, despite recognizing the demand-related advantages provided by *Rales*, might still expect the benefits of full board activity to outweigh those advantages. An ounce of prevention is worth a pound of cure, particularly considering the non-litigation costs (e.g., reputation costs) that can be incurred when decisions turn out poorly. At the very least, directors might feel confident enough in the merits of the case to avoid incurring settlement costs and might expect to be able to cut litigation off before other significant costs are incurred.

But what level of comfort can directors reach regarding the risk of prospective duty of care litigation? Will there be colorable duty of care claims despite their direct participation? The answer is almost certainly yes, keeping in mind that directors do not ask themselves whether they can prevent ultimately meritorious litigation by actively participating in corporate decision-making. The relevant issue instead, is the level of costs associated with *all potential* litigation (including distraction, settlement costs, and litigation fees), and whether they can be minimized or avoided by active director participation in the original decision-making process.

Directors' most significant protection from potential duty of care litigation is the combination of the pleading requirements of Chancery Rule 23.1 and the business judgment rule. Under Rule 23.1's pleading requirements, plaintiffs must plead particular facts that show demand would be futile.[102] This is generally understood to be a significant procedural burden.[103] All the while, these heightened pleading standards exist against the backdrop of the business judgment rule. In this regard, some scholars characterize the current standard for due care liability as requiring "little more of a director than a ritualistic consideration of relevant data."[104] On the other hand, others believe that a certain level of

102. *See* DEL. CT. C.P.R. 23.1 (requiring the plaintiff to allege "reasons for the plaintiff's failure to obtain the action or for not making the effort."); *Brehm*, 746 A.2d at 254 ("What the pleader must set forth are particularized factual statements that are essential to the claim.") (citations omitted).

103. DEL. CT. C.P.R. 23.1. *But see Brehm*, 746 A.2d at 268 (Hartnett, J. concurring) ("The reason for Rule 23.1 is judicial economy. It is not intended to preclude a judicial inquiry where the pleaded facts, if true, and any inferences that may be drawn from them . . . show the likelihood of misconduct by the directors."). For a more detailed discussion of the relative burdens created by Rule 23.1 and notice pleading under Rule 8(a), see Part V.B *infra*.

104. Stephen J. Lubben & Alana Darnell, *Delaware's Duty of Care*, 31 DEL. J. CORP. L. 589, 591 (2006); *see also Brehm*, 746 A.2d at 264 ("Due care in the decision-making context is *process* due care only."); *In re* Walt Disney Co. Derivative Litig. ("Disney IV"), 907 A.2d 693, 749-50 (Del. Ch. 2005) ("[C]ompliance with a director's duty of care can

substantive egregiousness will suffice to result in a violation of fiduciary duties.[105]

The fuzziness of the scope of the duty of care is but one example of the indeterminacy of Delaware corporate law.[106] But even if directors knew for certain that due care required, for example, only the "ritualistic consideration of relevant data," what are the contours of the ritual, and what data is relevant? As Ehud Kamar has observed:

> [C]orporate law is not an exact science. Rather, it is a set of loosely defined guidelines made concrete by courts after the fact. The messages the guidelines carry, in general, is that corporate fiduciaries simply must do their utmost to promote shareholder interests. Exactly what this means in practice is not clear. Although court decisions list relevant criteria for judging managerial behavior, these criteria are not exhaustive. Indeed, courts often emphasize their incompleteness, leaving the legal community wondering what additional criteria may prove relevant in the future.[107]

Delaware courts' decisions (including duty of care decisions) are extremely fact-sensitive.[108] Despite the best of intentions, they are likely subject to considerable hindsight bias.[109] Accordingly, it is exceedingly difficult to be sure that colorable litigation will not crop up prior to deciding whether to take an active role in making corporate decisions.[110]

Prudent directors, therefore, need not assume that board diligence would necessarily insulate them from duty of care claims, even with the protection of the business judgment rule. In the face of even a slightly indeterminate litigation risk and the magnitude of liability risk relative to

never appropriately be judicially determined by reference to *the content of the board decision* that leads to a corporate loss, apart from consideration of good faith or rationality of the process employed.") (quoting *Caremark*, 698 A.2d at 967).

105. *See* Rosenberg, *supra* note 69, at 320.

106. *See, e.g.*, Sean J. Griffith, *Good Faith Business Judgment: A Theory of Rhetoric in Corporate Law Jurisprudence*, 55 DUKE L.J. 1 (2005) (describing the way in which the Delaware courts' interpretation of "good faith" shifts over time in response to, *inter alia*, political pressures).

107. Ehud Kamar, *Shareholder Litigation Under Indeterminate Corporate Law*, 66 U. CHI. L. REV. 887, 891 (1999).

108. *See, e.g.*, Ehud Kamar, *A Regulatory Competition Theory of Indeterminacy in Corporate Law*, 98 COLUM. L. REV. 1908, 1915 (1998) (describing Delaware decisions as involving "loosely defined legal tests whose precise meaning depends on the particular facts of each case.").

109. *See, e.g.*, MELVIN ARON EISENBERG, CORPORATIONS AND OTHER BUSINESS ORGANIZATIONS 547 (8th ed. 2000) (explaining the hindsight bias).

110. To these questions of indeterminacy, one should add the directors' recognition (from a combination of modesty and awareness of time demands) that they might make procedural mistakes.

their personal net worth, directors are likely to be cautious.[111] Similarly, excessive directorial caution may stem from recognition of the costs imposed on the firm through litigation, even if such litigation does not result in success for plaintiffs. One would expect the differences between the demand futility tests in *Aronson* and *Rales* to allow directors a device for mitigating some of this risk—the relative advantage of delegation and monitoring vis-à-vis direct board decision-making.

B. Overdelegation at Work

Although there are multiple decision classes for which such delegation may make sense, executive compensation may be a particularly good example. First, delegation of certain compensation matters to board compensation committees is required or encouraged by the stock exchanges already. The New York Stock Exchange requires its listed companies to establish compensation committees comprised of independent directors and charge them with, at a minimum, reviewing and approving CEO goals and objectives relevant to his or her compensation, evaluating his or her performance in light thereof and, "either as a committee or together with the other independent directors (as directed by the board), determin[ing] and approv[ing] the CEO's compensation level based on this evaluation."[112] For non-CEO compensation, incentive-compensation and equity plan decisions, however, the compensation committee needs only "make recommendations" to the board.[113] Boards, of course, are free to require that a compensation committee do more than merely "recommend." Nasdaq companies, on the other hand, do not need to have compensation committees, but must either have a compensation committee comprised of independent directors or involve a majority of independent directors in compensation decisions.[114] Moreover, whatever form the decision-making body takes, its role need only be advisory.[115] Again, however, a board is free to require that a committee take on more responsibility.

Although not required, delegation by boards is advantageous given the tests of *Aronson* and *Rales.* The independence of compensation gatekeepers means that management compensation (as distinct from board

111. *See* Kamar, *supra* note 107, at 895-96. One way corporate law mitigates this potentially excessive caution is through director indemnification and insurance.

112. NYSE, Inc., Listed Company Manual § 303A(5) (2004).

113. *Id.* Compensation committees must also produce the compensation report that is to be included in the corporation's proxy statement.

114. NASDAQ, Manual, Rule 5605(d)(2009).

115. *See id.* (requiring the decision-maker to determine *or recommend* compensation to the board for determination). With respect to CEO compensation, a committee may make recommendations to the full board which may then decide the CEO's compensation, as long as the CEO takes no part in the deliberations. *Id.*

compensation) is not likely to pose serious duty of loyalty issues.[116] Thus, the majority of derivative suits in the executive compensation context generally fall into three categories. When a majority of the board acts, shareholders bring due care or waste claims against the board.[117] When the board delegates to a committee, shareholders bring care or waste claims against committee members and, perhaps, oversight claims against the board. When the board or committee delegates to management, shareholders bring oversight claims against the delegating body and, perhaps, duty of loyalty claims against management.[118] In the first type, claims against the board for board action, demand futility is evaluated under *Aronson*. In the second and third types, claims against the committee based on its decision or against the board or committee based on its failure to monitor demand futility is evaluated under *Rales*.[119]

Consider the Chancery Court's recent decision in *Desimone v. Barrows*. Shareholders of Sycamore Networks brought a derivative suit alleging, *inter alia*, breach of fiduciary duty by the board relating to the backdating of stock options awarded to employees and directors.[120] The

116. *See* Thomas & Martin, *supra* note 44, at 577-78 ("[Showing of financial interest] requires facts that would support . . . a taint of conflict of interest, facts that are more likely to be present in closely held companies than in public corporations. Many public corporations have compensation committees comprised mostly, if not exclusively, of disinterested outside directors."). As noted earlier, new exchange rules now require that publicly traded corporations have compensation committees comprised *exclusively* of disinterested directors.

117. *See id.* at 581 (examining the difficulties for shareholders when bringing breach of duty of care and waste claims in executive compensation suits). Recently, these complaints have also raised good faith claims. *See, e.g.*, *In re* Walt Disney Co. Derivative Litig. ("Disney V"), 906 A.2d 27, 46 (Del. 2006) (explaining that the duties to use due care and to act in good faith are distinct); *see also infra* Part V.A (extensively discussing good faith).

118. *See, e.g.*, *Desimone*, 924 A.2d at 933. In addition to suing a delegating compensation committee, shareholders may allege breach of oversight duties against, for example, an audit committee for not recognizing potential backdating risks. *Id.* at 940.

119. For a committee decision to qualify as a board "non-decision" and therefore qualify for *Rales* treatment, the committee must consist of less than half of the members of the board at the time demand would otherwise be required. *See* Ryan v. Gifford 918 A.2d 341, 353 & n. 29 (Del. Ch. 2007) ("Where at least one half or more of the board in place at the time the complaint was filed approved the underlying challenged transactions, which approval may be imputed to the entire board for purposes of proving demand futility, the *Aronson* test applies.").

120. *Desimone*, 924 A.2d at 912-13. Backdating involves the issuance of options with exercise prices below the market price of a share at the time of actual grant. If done explicitly, granting "in the money" options would violate prohibitions imposed by shareholder-approved stock plans and would have negative consequences under the tax laws and accounting rules. *See* I.R.C. § 162(m) (2000); Financial Accounting Standards Board, Statement of Financial Accounting Standards No. 123: Share-Based Payment (revised 2004) (hereinafter "FAS 123R"), *available at* http://www.fasb.org/pdf/fas123r.pdf. Backdating achieves the same economic effect as in-the-money options but avoids such consequences by pretending the date of grant was really at an earlier time when the share price was equal

option grants in question were divided among three groups of recipients, including rank-and-file employees and officers.[121] Importantly, the shareholders conceded that because of delegation no board action was taken with respect to any of the grants and that, consequently, *Rales* was the appropriate test for their demand futility claim.[122]

The Chancery Court analyzed the employee grants and the officer grants separately. With respect to the former, no directors were substantively interested or non-independent; therefore, the only question under *Rales* was whether the directors faced a substantial threat of personal liability as a result of the backdating.[123] The employee grants had not been made by the board or compensation committee, but were instead made by an executive to whom the compensation committee was assumed to have delegated authority.[124] Because the directors were not directly involved, the only claim available to shareholders was that the directors failed in their duty to oversee the executive to whom they entrusted the power to make the grants.[125] The court concluded that no substantial likelihood of personal liability under *Caremark* existed when there were no allegations that the board knew a problem existed and failed to take remedial actions to curtail the executive's behavior.[126]

The court's analysis of the officer grants is more interesting. The shareholders did not allege that directors knowingly backdated the officer grants.[127] However, the court did infer that the compensation committee approved the amount and recipients of the officer grants.[128] But it refused to infer that the committee "was involved in the mechanics by which the options were issued or the dates on which that administrative task was carried out."[129] In addition, the court concluded that there would be no reason to doubt the other directors' abilities to judge demand fairly, even if the compensation committee members had breached their fiduciary

to the desired exercise price. The complaint also alleged "spring-loading" and "bullet-dodging"—practices which, alternatively, time grants so that they occur in advance of positive news or time grants so that they occur following negative news. *Desimone*, 924 A.2d at 915-17.

121. *Desimone*, 924 A.2d at 913. The third group of recipients was non-employee directors. *Id.*

122. *Id.* at 913-14. The board apparently delegated option-granting power to the compensation committee for the employee and officer grants, and the non-employee director grants were self-executing as per the equity plan. *Id.* at 949.

123. *Id.* at 938.

124. *Id.* at 938-39.

125. *Id.* at 939.

126. *See id.* at 940 (applying a post-*Stone v. Ritter Caremark* analysis). For a detailed description of *Caremark* duties, see Part V.A *infra*.

127. *Desimone*, 924 A.2d at 942.

128. *Id.*

129. *Id.*

duties.[130] These other directors took no part in the granting of options. As for any duty of oversight claims against the non-committee directors, the court summarily dismissed the idea, presumably because a board delegates to a committee specifically to avoid any substantial oversight responsibility.[131] Thus, the board that avoids managing the option-granting process by delegating the job to a committee (which, in this case, delegated the job to management) found itself well protected by *Rales* and the limitations inherent in the duty of oversight.

But imagine an alternative world in which the Sycamore board was more significantly involved in the mechanics of issuing the officer grants. On the one hand, the directors could have prevented backdating had they been actively involved. On the other hand, if the backdating nevertheless occurred, demand would have been judged under *Aronson* rather than *Rales*. Director involvement provides both risk and reward from a litigation perspective.

To determine whether this matters, one might want to know how a more active compensation committee or board could have allowed options to be manipulated. First, they may have been complicit in the manipulation. Perhaps the board wanted officers to receive higher compensation than the circumstances would otherwise allow.[132] Backdating, for instance, would allow payments to be made to the officers without their full cost appearing in the corporation's financial statements.[133] Under these circumstances, the board would need to be involved in the option granting to guarantee the backdating, so any differences between *Rales* and *Aronson* are beside the point.

Alternatively, the active directors could make a mistake. They may misunderstand the accounting rules, not receive enough information

130. *Id.*

131. *Id.*

132. *See, e.g.*, LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE 35-36 (describing outrage costs—imposed by shareholders, press, politicians and the public at large—as a meaningful constraint on directors transferring wealth from the corporation to executives). Bebchuk and Fried note that the directors' motivation for making these high payments run the gamut from the tangible—preserving their seat on the board—to the intangible—being a "team player" within the corporate hierarchy. *Id.* at 25-34.

133. For the seminal article on this form of "secret" compensation, see Iman Anabtawi, *Secret Compensation*, 82 N.C. L. REV. 835 (2004). *See also* Opinion 25: Accounting for Stock Issued to Employees (Accounting Principles Board 1972); ACCOUNTING FOR STOCK BASED COMPENSATION, Statement of Fin. Accounting Standards No. 123 (Fin. Accounting Standards Bd. 1995). Under FAS 123R, the balance sheet benefit of backdating for accounting purposes is only the incremental share price increase from the alleged date of grant to the actual date of grant. Under prior accounting rules, the benefit was more dramatic because companies took no compensation charge for options that were granted at- or out-of-the-money. Thus, backdating allowed companies to remove the *entire* cost of the options from their financial statements. ACCOUNTING FOR STOCK BASED COMPENSATION, Statement of Fin. Accounting Standards No. 123 (Fin. Accounting Standards Bd. 1995).

regarding the accounting and tax implications of backdating, not receive enough factual information regarding the option grants, or simply make a terrible error in judgment. In any of these cases, there would seem to be a colorable due care claim,[134] and there would be a significant risk that demand would be excused under *Aronson*'s second prong. As long as the possibility of director error or *ex post* judicial error exists, then, *Aronson*'s second prong invites directors to delegate decisions away.

Desimone was not the only option backdating case to be decided in recent years by Delaware courts. The Chancery Court had two other cases before it alleging improper manipulation of equity awards. In both *Ryan v. Gifford* and *In re Tyson Foods, Inc. Shareholder Litigation*, defendant directors moved to dismiss the respective derivative suits for failure to make a demand.[135] In both *Ryan* and *Tyson*, the motion was denied.[136] Finally, in both *Ryan* and *Tyson*, the boards had taken action regarding equity awards that formed the basis of the complaints.[137] Admittedly, *Ryan* and *Tyson* involved allegations of intentional disloyalty by the board, neither of which was alleged with any particularity in *Desimone,* even with respect to the compensation committee members themselves.[138] We should expect directors who are lining their own pockets or those of their friends to be treated more harshly than those who seem only asleep at the wheel. Nevertheless, it may seem to some that board inaction fares better in litigation than does board action. One cannot help thinking that directors or their advisers who think about these cases are likely to see the litigation advantages to be gained by delegating authority over such decisions.[139]

C. *The Managerial Board*

If *Rales* and *Aronson* combine to promote overdelegation, the question remains whether increased delegation by boards is problematic. Much recent corporate law commentary recommends that directors play a greater role in the corporate decision-making process.[140] Of course, board

134. *See, e.g.*, Bainbridge, *supra* note 1, at 275-83.

135. Ryan v. Gifford, 918 A.2d at 351-52 (Del. Ch. 2007); *In re* Tyson Foods, Inc. Consol. S'holder Litig., 919 A.2d 563, 583 (Del. Ch. 2007).

136. *Ryan*, 918 A.2d at 354-55; *Tyson*, 919 A.2d at 583-84.

137. *Ryan*, 918 A.2d at 353 (noting that "one half of the current board members approved each challenged transaction"); *Tyson*, 919 A.2d at 573-79. *See also Ryan*, 918 A.2d at 355-56 (stating that the Chancery Court also judged demand futility under *Rales* and determined that demand would have been excused even under that test because a majority of the board members faced a substantial risk of personal liability).

138. Desimone v. Barrows, 924 A.2d 908, 929-30 (Del. Ch. 2007).

139. As in *Desimone*, the delegation need not be full. It need only be a delegation of the part of the process carrying a high litigation risk, in this case, the "mechanics" of the option granting.

140. *See, e.g.*, Eric A. Reitman, *Panacea Later: A Critical Evaluation of the Board*

involvement in that process can mean different things. On the one hand, the full board can actively make decisions over certain spheres of corporate activity. On the other hand, the full board can delegate to management and thereafter monitor management's performance. In between, the board can delegate authority over certain activities to committees of the board, which must then make separate determinations as to retaining the authority or delegating it further to management.[141] Advocating for a more active board does not commit one to the view that boards should not ever delegate.

In fact, there are reasons to think that delegation of either type—to committees or to management—can be a good thing. A certain amount of delegation to management is necessary for the efficient operation of a large firm.[142] Moreover, as corporations have increasingly turned to independent directors, delegation to management may be desirable if independent directors lack the firm-specific information needed to manage effectively.[143] As for committees, their use allows boards to select decision-makers who may bring expertise in specialized areas.[144] Moreover, although independent directors on these committees may suffer from informational deficiencies relative to corporate insiders, they will likely suffer less than the other directors from managerial capture.[145]

While delegation (and monitoring) may be an appropriate role for

Orthodoxy in Corporate Governance Scholarship and Proposal of a Board-less Alternative for the Diffusely Owned Public Corporation, 1 VA. L. & BUS. REV. 239 (2006) (observing and criticizing the central role that board action plays in corporate governance scholarship). For a selection of just the most recent scholars to assume or explicitly state that directors should be more involved in some level of corporate decision-making, see, e.g., Elizabeth Cosenza, *The Holy Grail of Corporate Governance Reform: Independence or Democracy*, 2007 B.Y.U. L. REV. 1, 18-19 (2007); Eric M. Fogel and Andrew M. Geier, *Strangers in the House: Rethinking Sarbanes-Oxley and the Independent Board of Directors*, 32 DEL. J. CORP. L. 33, 67-71 (2007) (arguing for the establishment of shareholder-directors who will become more involved in monitoring management); Nowicki, *supra* note 93, at 481-90 (suggesting the employment of "professional directors" as a means of better corporate governance).

141. As noted above, stock exchanges have begun to require or encourage the use by listed companies of certain board committees.

142. *See*, *e.g.*, Kenneth Arrow, THE LIMITS OF ORGANIZATION 68-70 (1974). Also refer to Roberta S. Karmel, *The Independent Corporate Board: The Means to What End?*, 52 GEO. WASH. L. REV. 534 (1984) (describing the efficiency costs imposed by board involvement).

143. *See* Fisch, *supra* note 97, at 283.

144. *See, e.g.*, Anup Agrawal & Shiba Chadha, *Corporate Governance and Accounting Scandals*, 48 J.L. & ECON. 371, 394-96 (2005) (discussing the impact of accounting expertise on board audit committees).

145. *See, e.g.*, John H. Matheson & Peter D. Favorite, *Multidisciplinary Practice and the Future of the Legal Profession: Considering a Role for Independent Directors*, 32 LOY. U. CHI. L.J. 577, 609 (2001); Ira M. Millstein & Paul W. MacAvoy, *The Active Board of Directors and Performance of the Large Publicly Traded Corporation*, 98 COLUM. L. REV. 1283, 1291 (1998).

most boards with respect to most decisions, it is not necessarily true that *all* boards should delegate *all* decisions. Boards may very well have a managing function in addition to a monitoring function, which includes, *inter alia*, strategic planning, reviewing the structure of significant corporate transactions and making compensation decisions.[146] Some of these functions are practically non-delegable, regardless of the incentives created by the demand requirement.[147] Others, like CEO compensation, are more or less subject to forced delegation.[148] Between the two extremes, however, lies a broad swath of corporate decision-making in respect of which directors may decide whether or not to delegate their authority.[149]

Left to their own devices, we can expect a fair amount of heterogeneity as boards come to different conclusions as to how best to strike the balance between managing and monitoring. However, *Aronson* and *Rales* combine to provide an exogenous push towards delegation with subsequent monitoring. Incentives to deviate from a particular board's management/delegation baseline towards more delegation should give one pause. A board's decision to fully delegate to management and exclusively adopt a monitoring role may not always be optimal. Monitoring by outside directors is likely to be imperfect and may provide management with the breathing room in which to make decisions that fail to maximize firm value. The non-litigation advantages of delegation may often outweigh the advantages of board decision-making. But unless that is always the case, the incentives created by the differing demand regimes toward more delegation will cause some amount of harm.

There are at least some reasons to suspect that it is not the case that board delegation will always be the best decision. As a response to the regulatory requirements discussed above, committees established by boards tend to consist solely of independent directors.[150] These independent directors are less likely to have the most extensive information regarding a corporation. Accordingly, they may not be capable of making the best decisions for the corporation in certain contexts.[151] Alternatively, increased

146. *See* Fisch, *supra* note 97, at 272-74 ("Board function need not be viewed solely in terms of monitoring management.")

147. Consider approval of a dissolution where a board was comprised of solely disinterested directors.

148. *See supra* note 112 and accompanying text.

149. *See* Fisch, *supra* note 97, at 285 (noting that the appropriate management role of boards may extend past non-delegable duties for certain firms in certain circumstances).

150. Boards seeking to delegate to committees to take advantage of *Rales* outside of the contexts proscribed by regulations could certainly establish ad hoc committees consisting, in part, of inside directors.

151. An obvious example of this phenomenon can be observed with respect to compensation committee decisions relative to executives with whom the committee has little interaction or over whom the committee has less regular oversight.

usage of committees may cause resentment and antagonism on boards, impairing the ability of boards to operate optimally.[152] Moreover, larger groups (such as boards) may perform better than smaller groups (like committees) or individuals.[153]

Finally, even if delegation and subsequent monitoring were always advisable, many of the activities that traditionally fall within "monitoring" require some board action.[154] Good monitoring will often require board decision-making,[155] particularly when the monitor needs to express disapproval of the delegate's actions and effect a change of course. Thus, *Aronson's* second prong may even provide monitors with incentive to delegate more and monitor *less*.

V. OBJECTIONS

This Article has contended that (1) *Aronson's* second prong allocates authority away from the board even in instances where Delaware courts have not traditionally viewed a board as compromised and (2) when combined with the different test for demand futility in *Rales*, that second prong provides incentives for rational boards to take a less active role in corporate decision-making than they might have otherwise.

The latter argument—that *Aronson* and *Rales* combine to create incentives for overdelegation—invites at least two critiques. First, it may be that boards' incentives to delegate have been diminished by recent Delaware jurisprudence announcing directors' obligations to act in good faith. Good faith is a prerequisite for coverage under exculpatory statutes, and therefore key to evaluating the likelihood of potential director liability under *Rales*. If excessive delegation leads to an absence of good faith,[156] then this line of cases may provide a practical solution to the overdelegation problem.

152. *See* Jill E. Fisch & Caroline M. Gentile, *The Qualified Legal Compliance Committee: Using the Attorney Conduct Rules to Restructure the Board of Directors*, 53 DUKE L.J. 517, 544 (2003).

153. *See* Bainbridge *supra* note 21, at 42-43 (discussing advantages of large boards versus small boards).

154. *See* Fisch, *supra* note 97, at 270-71 ("Recent efforts to improve board *monitoring* have included revising director qualification standards to encourage greater use of directors without relationships that could interfere with independent *action* . . . Committees are particularly useful for effecting board *monitoring* because they allow independent directors to *make decisions* free from the risk of domination by insiders.") (emphasis added).

155. *See* Stephen M. Bainbridge, *Independent Directors and the ALI Corporate Governance Project*, 61 GEO. WASH. L. REV. 1034, 1064 (1993) ("Monitoring the performance of senior executives is the board's major function, but that necessarily involves activities that can best be described as managing the corporation.").

156. *See* Nowicki, *supra* note 93 (noting the danger in conflating "not in good faith" with "bad faith").

The second criticism applies to both the board authority and overdelegation points. One might agree that the demand requirement provides incentives for boards to delegate away more of their authority than they would otherwise choose. One might further agree that *Aronson's* second prong fails to give enough deference to board authority in circumstances where they are unlikely to face personal liability. Nevertheless, one might point out that the demand requirement is only one part of the litigation process. The subsequent (and sometimes simultaneous) step—a motion to dismiss under Rule 12(b)(6)—allows a board protected by an exculpatory clause to move for dismissal and nip any litigation in the bud, even if demand is excused under *Aronson's* second prong. Thus the exculpatory clause may still provide an effective safety net for the directors just beyond the demand stage. If so, this would eliminate any practical differences between the decision-making board and the delegating board regarding demand futility and would minimize any incursion on board authority.

A. Good Faith as a Check on Overdelegation

Key to the overdelegation analysis in Part IV is the idea that the *Rales* test provides a relatively safe landing spot for boards who delegated away decision-making authority over a broad array of decisions. Under the *Rales* test, and assuming no obvious director interest or non-independence with respect to the underlying matter, demand is excused only when directors face a substantial likelihood of personal liability. Considering the ubiquity of exculpatory clauses, this requires that shareholders allege with particularity that directors have breached their duty of good faith.[157] If overdelegation demonstrates an absence of good faith, then directors would not be protected by the exculpation statute. Consequently, the *Rales* test would be satisfied and board delegation would not receive preferential treatment for demand futility purposes.

In Delaware, directors owe shareholders a duty of oversight, i.e. a duty to monitor subordinates. Chancellor Allen first outlined the modern version of this duty in *In re Caremark International Inc. Derivative Litigation.* Prior to *Caremark*, the duty of oversight was invoked only when directors had cause to suspect that management or employees were involved in illicit or harmful behavior.[158] To some extent, ignorance was

157. Loyalty claims to the extent distinct from good faith claims would also qualify to make directors personally liable.

158. *See* Graham v. Allis-Chalmers Mfg. Co., 188 A.2d 125, 130 (Del. 1963) ("[A]bsent a cause for suspicion there is no duty upon the directors to install and operate a corporate system of espionage to ferret out wrongdoing which they have no reason to suspect exists.").

bliss.[159] *Caremark* retreated from that limited conception of a board's oversight responsibility. The duty of oversight would always be "active" but would only be violated by a sustained or systematic failure of the board to exercise oversight.[160] A failure to oversee rises to that level if (1) no reporting system or controls was implemented or (2) the board consciously failed to monitor or oversee those systems that do exist.[161] Chancellor Allen noted the high bar imposed by this standard, but observed: "[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, 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."[162]

Caremark was understood to be a duty-of-care case.[163] Chancellor Allen did, however, use the phrase "good faith" in describing the duty of oversight and the test to be applied. The use of "good faith" implicated Section 102(b)(7) exculpation clauses, but *Caremark* did not specifically discuss the relationship between the duty of oversight and exculpation clauses.[164] The issue was not relevant in the case because the court was deciding whether to approve a settlement that imposed no personal liability onto the directors.[165]

The connection between oversight and good faith (and therefore Section 102(b)(7) exculpation clauses) was first given significant judicial attention in the now-famous Disney litigation.[166] Although the Disney directors were ultimately held to have satisfied their duties of good faith, the Disney cases made clear that a breach of the duty of oversight would not be exculpable under Section 102(b)(7) clauses because the duty of oversight was a species of the duty of good faith.

159. *See* Bainbridge, *supra* note 1, at 293-94 (advocating the "every dog gets one bite" rule, under which analogy the "dog" is management or other employees and the dog's "owner" who won't be liable to the first victim of the dog is the board)

160. *See In re* Caremark Int'l. Inc. Derivative Litig., 698 A.2d 959, at 971.

161. *See* Stone v. Ritter, 911 A.2d 362, at 370 (approving the *Caremark* test).

162. *Id*. (emphasis omitted)

163. *See supra* note 78; Hill & McDonnell, *supra* note 8, at 841 and n. 36 (noting that *Caremark* characterized the question of good faith as "coming within the duty of care" and citing authority for that proposition).

164. Chancellor Allen did cite *Baxter's* dismissal of a similar suit because of the existence of an exculpatory clause as support for his conclusion that the shareholders' claims in *Caremark* "quite likely were susceptible to a motion to dismiss in all events." 698 A.2d 959, at 971, fn 28.

165. *Id*. at 960.

166. *See generally In re* Walt Disney Co. Derivative Litig., 731 A.2d 342 (Del. Ch. 1998) ("Disney I"); *Brehm v. Eisner*, 746 A.2d 244 (Del. 2000); *In re* Walt Disney Co. Derivative Litig., 825 A.2d 275 (Del. Ch. 2003) ("Disney II"); *In re* Walt Disney Co., 2004 WL 2050138 (Del. Ch. 2004) ("Disney III"); *Disney IV*; and *Disney V*.

The facts of the Disney cases have been summarized more fully elsewhere but a brief summary will be helpful.[167] Disney needed to hire a second-in-command to serve under CEO Michael Eisner and Eisner settled on Michael Ovitz. According to its governing documents, Disney's board was charged with appointing all officers, including the President (the position to be held by Ovitz).[168] Furthermore, the compensation committee's charter charged it with approving all compensation for the President and all employment contracts of Disney officers.[169] Ovitz and the company negotiated a pay package (including very generous severance terms), the committee approved the package and the board elected Ovitz as President. The committee's approval and the board's election occurred after a process that, according to the court, "fell significantly short of the best practices of ideal corporate governance."[170] Specifically, it was unclear until trial whether any of the Disney directors had quantified the severance potentially owed to Ovitz.

Within a short period of time, Ovitz' employment was terminated and he received the severance payment. Shareholders filed a derivative suit claiming, *inter alia*, violations by the Disney directors of their duties of loyalty, due care and good faith. A trial eventually ensued, after which Chancellor Chandler held that the directors had not breached any fiduciary duties. The Delaware Supreme Court subsequently affirmed that decision in *Disney V*.

The *Disney V* decision need not have spent much energy on a discussion of the duty of good faith. As the court noted, the shareholders argued that the directors had acted in bad faith *because* they had acted without due care.[171] The court agreed that the shareholders had not proven any violation of the duty of care, so they necessarily failed to prove bad faith.[172]

Nevertheless, the court went on to outline the contours of the duty of good faith in dicta. First and contrary to plaintiff's contentions, mere lack of due care—gross negligence—was not enough to demonstrate an absence of good faith.[173] Most importantly for present purposes, the court noted that the duty of good faith could be violated "where the fiduciary

167. *See, e.g.*, Hill & McDonnell, *supra* note 8, at 843-845 (reviewing the main facts in the Disney litigation).

168. *Disney IV*, 907 A.2d at 771.

169. *Id.* at 763-64.

170. *Id.* at 697.

171. *See Disney V*, 906 A.2d at 63.

172. *Id.*

173. *Id.* at 64-66. The court recognized the need to distinguish due care from good faith based on the legislature's passage of (1) § 102(b)(7) and (2) § 145(a) and (b) and the distinction those statutes make between acts taken in good faith and those taken in bad faith. For criticism of this approach, see Bainbridge et al., *supra* note 78, at 33-34.

intentionally fails to act in the face of a known duty to act, demonstrating a *conscious disregard for his duties*."[174] Equating a conscious disregard of duties with an absence of good faith meant that a breach of the oversight duty (along with other conscious breaches) would not be exculpable under Section 102(b)(7) provisions.

Soon after *Disney V* came the Supreme Court's decision in *Stone v. Ritter*. *Stone* was another case concerning an alleged breach of a board's duty of good faith via the duty of oversight. The court in *Stone* explicitly adopted the *Caremark* "sustained or systematic failure" standard for evaluating oversight liability, and went on to note that such a standard was fully consistent with the "conscious disregard of duties" standard set forth in *Disney V*. [175] In particular, *Stone* held that liability in the oversight context "requires a showing that directors *knew* that they were not discharging their fiduciary duties."[176]

In sum: if directors violate their duty of oversight announced in the *Caremark/Disney/Stone* line of cases, they face a substantial likelihood of personal liability for oversight claims because they would not be exculpated for their lack of good faith. Accordingly, one might think that *Rales'* demand futility test provides no comfort for boards whose delegation created a colorable claim for breach of the oversight duty.

Nevertheless, three considerations cut against that conclusion. First, the delegation that is contemplated by the duty of oversight is delegation to management. There does not seem to be a judicially recognized duty of the board to monitor a board committee. Thus, the duty of oversight provides no disincentive for overdelegation to committees.

Second, leaving committee delegation aside, directors may violate their good faith obligations by failing to monitor management to whom they delegate. That does not mean that directors violate those obligations by failing to actively make decisions. Delegation itself does not violate the duty of oversight—it merely activates it. Considering the informational disadvantages they face relative to the actors they are supposed to oversee, we have reason to be concerned that boards will systematically fail to rigorously monitor management, even if that failure does not rise to a *Caremark* violation.

Third, even if good oversight is difficult, directors have little reason to worry that shareholders will be able to meet the *Caremark/Stone* test. Indeed, one scholar described the standard announced in Caremark "more like a Potemkin village than a revolution," "requir[ing] a showing of some extreme directorial misconduct when it c[omes] to monitoring the activities

174. *See Disney V*, at 67 (emphasis added) (quoting Chancellor Chandler's language from *Disney IV*).

175. *See Stone*, 911 A.2d at 369.

176. *Id.* at 370 (citing *Guttman*, 823 A.2d at 506).

of subordinates."[177] *Caremark* duties are so hard to violate that there has been only one instance—an unpublished opinion—in which a Delaware court held directors liable for breach of the oversight duty.[178]

In a slightly different context, the duty of good faith had been treated expansively by at least one court. In *Ryan v. Lyondell Chemical Co.,*[179] Lyondell's directors had approved a merger of the company with Basell AF, wherein Lyondell's shareholders were cashed out for $13 billion, or $48 per share. Lyondell's shareholders sued, claiming breach of the duty of care and breach of the duty of loyalty, the latter on "good faith," disclosure and "financial self-interest" grounds.[180] As to due care, the plaintiffs alleged that the directors violated their *Revlon* duties[181] by failing to actively take steps to ensure that the sales process would achieve the highest price available for the shareholders.[182] Defendants countered that Lyondell's charter contained an exculpation clause shielding directors from liability for due care breaches.[183] Plaintiffs responded that the *Revlon* claims, which sounded in the duty of care, nonetheless implicated the duty of good faith (and were therefore non-exculpable) because the directors knew they were violating their *Revlon* duties. In a somewhat surprising ruling,[184] Vice Chancellor Noble denied the directors' motion for summary judgment based on the exculpation clause because "[t]he record, as it

177. *See* Harry Gerla, *Caremark — The Failed Revolution*, http://www.theracetothebottom.org/home/caremarkthe-failed-revolution.html.

178. *See* ATR-Kim Eng Financial Corp. v. Araneta, 2006 WL 3783520 (Del. Ch. 2006). In a recent opinion, Vice Chancellor Strine allowed an oversight claim to survive a motion to dismiss where the claim only involved a Caremark-type legal compliance issue. *See* In re American Int'l Group, Inc., 965 A.2d 763 (Del. Ch. 2009).

179. Ryan v. Lyondell Chemical Co., 2008 WL 2923427 (Del.Ch., July 29, 2008).

180. *Id*. at 1-3.

181. *See* Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986) (formulating the concept of *Revlon* duties that are owed in the context of mergers).

182. *See Lyondell*, 2008 WL 2923427 at *1. Plaintiffs also complained that the directors had adopted preclusive and coercive deal protection measures in violation of *Unocal Corp. v. Mesa Petroleum Co.,* 493 A.2d 946 (Del. 1985) and *Omnicare, Inc. v. NCS Healthcare, Inc.*, 818 A.2d 914 (Del. 2003).

183. *Id.* at *18.

184. *See* Posting of Jeff Lipshaw to Legal Profession Blog, http://lawprofessors.typepad.com/legal_profession/2008/07/reactions-to-ry.html (July 31, 2008) (reacting to the Delaware Court of Chancery's ruling in *Ryan v. Lyondell*); Eric Chiappinelli, *Delaware Court of Chancery on Good Faith and the Duty of Loyalty in a Revlon Setting*, CASES AND MATERIALS ON BUSINESS ENTITIES: NEW DEVELOPMENTS, http://businessentitiesonline.typepad.com/new_developments/2008/08/delaware-court.html (denouncing the ruling). *But see* Gordon Smith, *Boosters of "The Fiduciary Duty of Good Faith" Rejoice*, THE CONGLOMERATE, Aug. 13, 2008, http://www.theconglomerate.org/2008/08/boosters-of-the.html (observing that *Ryan* was "a pretty safe and uncontroversial ruling"). Additionally, under a relatively similar fact pattern, another member of the Chancery Court came down on the other side of the good faith issue. *See* McPadden v. Sidhu, 2008 WL 4017052 (Del. Ch. 2008).

presently stands, does not, as a matter of undisputed material fact, demonstrate the Lyondell directors' good faith discharge of their *Revlon* duties—a known set of 'duties' requiring certain conduct or impeccable knowledge of the market in the face of Basell's offer to acquire the Company."[185]

Any expansion of good faith in *Ryan* was short-lived. After taking an interlocutory appeal, the Delaware Supreme Court ruled, among other things, that a good faith claim could be stated "[o]nly if [the board] knowingly and completely failed to undertake their responsibilities" and that the proper inquiry for a good faith claim is whether the board "utterly failed" to attempt to fulfill its duties.[186] After Ryan, consider a board faced with a set of decisions having a high due-care risk profile—perhaps incentive compensation for non-CEO employees—. Why not hand those decisions off to management? The directors could theoretically be inviting a *Caremark/Stone* claim. But the well-advised board might simply establish maximum limits on aggregate awards and might require management to comply with a minimal periodic reporting system.

Under these circumstances, there would not be an "utter failure" to establish an oversight system. And the minimal oversight system is not likely to show that the directors were consciously disabling themselves from being informed of risks that required their attention. Exactly what risks required the directors' attention? Perhaps, in light of recent backdating scandals, directors should know that there is a serious accounting (and therefore securities fraud) risk in improperly administering stock compensation programs. However, the *Desimone* decision indicates otherwise. Shareholders there argued that the directors failed to oversee the executives to whom they delegated option-granting "mechanics," at least for awards made to officers and employees. The Chancery Court held that the failure to oversee the executives was not a violation of good faith, in part because the court refused to infer that directors knew that options were being backdated.[187] It was not enough to allege failure to oversee in the context of the general risk posed by equity grants. Instead, to satisfy the *Caremark/Stone* standard, the ignored risks had to be more company-specific to be deemed "known" by directors. It seems to be the case that "[a]s long as the board has put something in place, courts are almost certain

185. *See Lyondell*, 2008 WL 2923427, at *19.

186. Lyondell Chemical Co. v. Ryan, 2009 WL 1024764 at *7 (Del. 2009).

187. *See* Desimone v. Barrows, 924 A.2d 908, at 940-42. Hillary Sale argues that, in failing to notice backdating, a compensation committee "may have breached their good-faith obligations." *Supra* note 76, at 749-50. If *Desimone* is correct, though, compensation committees will not be liable for backdating that occurs under their watch absent a reason to suspect wrongdoing. Given the uproar surrounding the problems associated with equity compensation, it is doubtful, *a fortiori*, that other compensation decisions would subject committees to anything more demanding than the *Desimone* analysis.

to defer to the board . . . absent further suspicious facts."[188]

Even if knowledge of ignored risks could be inferred in the "suspicious" option-granting context, it says nothing about other areas, such as employment contracts, that don't involve the possibility of securities fraud. In *Disney*, there was no statutory requirement that the board elect Ovitz as President or that the compensation committee approve his employment contract. Those lines of authority were established in the company's governing documents. A corporation could just as easily *not* require its board to be involved in such decisions.[189] In fact, many of a company's largest employment contracts may be negotiated solely by management without any input from the board.[190] It is hard to imagine that a *pro forma* oversight process regarding such contracts would violate the duty of good faith. In fact, the Chancery Court was explicit in its final *Disney* decision that, to the extent no governing document required management to keep the board involved in the employment agreement negotiation, Eisner's behavior could not have violated the law.[191]

Thus, the duty of oversight should do little to cause directors to alter their management/delegation preferences significantly. This is not to say that *Caremark* and *Stone* are wrongly decided or too director-friendly. The extremely high bar set in *Stone* follows Chancellor Allen's observation in *Caremark* that a violation of the duty of oversight "is possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment."[192] Given the need to delegate at least some amount of corporate decision-making, it would be difficult to attract directors if they faced significant personal liability simply because of that delegation. However, the duty of oversight should not be expected to establish a substantial likelihood of personal liability for any but the most egregiously bad monitor. And even this assumes that the board did not first delegate to a board committee. In that case, as discussed above, *Rales* will likely always apply and boards will apparently receive the full protection of the demand requirement without necessarily reaching a *Caremark/Stone* analysis. Accordingly, the duty of good faith cannot carry much weight in the struggle to reduce the incentives to overdelegate.

188. Hill & McDonnell, *supra* note 79, at 1792.

189. Shareholders may object to the absence of such provisions, of course.

190. One can imagine the negotiations between a star news anchor and a television network or a professional athlete and a team owned by a corporation.

191. *See Disney IV*, 907 A.2d 693, 763 (noting, however, that such actions did not "comport with how fiduciaries of Delaware corporations are expected to act").

192. *Caremark*, 698 A.2d at 967.

B. *The § 102(b)(7) Motion to Dismiss as a Safety Valve*

The second objection to the argument about overdelegation proceeds from an observation about procedure. It applies equally to concerns outlined in Part III regarding board authority. One might agree that directors are better off, in terms of avoiding personal liability, by delegating authority. But perhaps that result has more to do with the impossible-to-meet *Caremark*/*Stone* standard than any distinction between *Rales* and *Aronson*. Indeed, the heavy burden of establishing a breach of good faith through the duty of oversight is likely more important to boards than any difference between the two demand futility tests.[193]

Along this line, although duty of care claims may be problematic for directors at the demand stage under *Aronson*, those directors can immediately move to dismiss the claims if exculpated under their corporation's charters. If those motions are as effective in protecting directors as a properly structured demand futility test would be, directors should have no preference between board action and board non-action. Similarly, any blow to board authority arising from *Aronson*'s second prong would be softened by the availability of a contemporaneous motion to dismiss.

It is true that Delaware courts have made it generally easy for directors to have duty of care claims extinguished through the invocation of exculpatory clauses. Defendant directors may invoke the clause at the motion to dismiss stage after demand has been deemed futile.[194] Such a clause disposes of the suit "where the factual basis for a claim *solely* implicates a violation of the duty of care."[195] Assuming the shareholder complaint did not raise the issue of the exculpatory clause, a motion to dismiss on the basis of such a clause is converted into a motion for summary judgment.[196] Although a summary judgment motion, the "floodgates of discovery" are not necessarily opened to plaintiffs.[197] For all

193. Unlike the distinction between test in *Rales* and *Aronson*, however, *Caremark*'s permissive treatment of director oversight is at least explainable: the board has limited resources with which to monitor management and a more stringent test would discourage people from becoming directors. *See, e.g., supra* note 142 and accompanying text*; see also* Gagliardi v. TriFoods Int'l, Inc., 683 A.2d 1049, 1051 (Del. Ch. 1996) (describing the protections provided for directors' actions made in good faith as an "elementary precept of corporation").

194. *See Malpiede v. Townson*, 780 A.2d 1075, 1092 (Del. 2001) (discussing when a Section 102(b)(7) defense can be raised).

195. *Emerald Partners v. Berlin*, 726 A.2d 1215, 1224 (Del. 1999) (emphasis in original).

196. *See Malpiede*, 780 A.2d at 1092 (specifically describing the process of this conversion).

197. *Id.* at 1091 (limiting discovery in this context to "a scope that is coextensive with the [exculpatory clause] issue necessary to resolve the motion").

intents and purposes, then, exculpatory clauses can be used to terminate a due-care-only derivative suit at a very early stage in litigation.

However, two procedural aspects of motions to dismiss on the basis of exculpation—relevant pleading standards and burdens of proof—pose problems. Importantly, failure-to-make-demand motions are judged under "stringent" pleading standards requiring factual particularity.[198] Plaintiffs must set forth the factual statements that are "essential to the claim."[199] Courts again may make inferences in a plaintiff's favor, but the inferences may only be drawn from particularized facts.[200]

Motions to dismiss (or summary judgment motions) based on exculpatory clauses are subject to more relaxed standards. In many cases, the motions are judged strictly on the pleadings, and therefore under notice pleading standards established by Chancery Rule 8(a).[201] Notice pleading requires the reviewing court to assume all well-pleaded allegations in the complaint and dismiss a complaint only if the court has "'reasonable certainty' that the plaintiff could prevail on no set of facts that may be inferred from the well-pleaded allegations in the complaint."[202] As Chancellor Chandler has recently noted: "To survive a Rule 12(b)(6) motion, a plaintiff need only plead so as to give notice of the claim; even vague allegations, so long as they give the opposing party notice of the claim, are well-pleaded."[203] Importantly, particularity is not required.[204] Instead, a court may make inferences from "general, if not conclusory, allegations."[205] Delaware courts are not shy about describing the magnitude of difference between Rule 23.1 pleading and notice pleading requirements.[206] Indeed, at least one court has noted that the disparities between 23.1 and 8(a) would cause it to decide a motion differently.[207]

198. *See, e.g., Brehm*, 746 A.2d at 254 (describing how the pleading in derivative suits differ than those governed strictly by Chancery Rule (8)(a)).

199. *Id.*

200. *See Tyson*, 919 A.2d at 582 (describing procedure in the Rule 23.1 context).

201. *See* DEL. CT. CH. R. 8(a).

202. *Malpiede*, 780 A.2d at 1082-83.

203. *McPadden*, 2008 WL 4017052, at *6.

204. *See Desimone*, 924 A.2d at 928 (describing differences between the Rule 23.1 and 12(b)(6) standards).

205. *Tyson*, 919 A.2d at 582

206. *See, e.g.*, *Brehm*, 746 A.2d at 254 ("[Rule 23.1's pleading requirements] differ substantially from the permissive notice pleadings governed solely by Chancery Rule 8(a)."); *Malpiede*, 780 A.2d at 1083 ("This [notice pleading] standard . . . is less stringent than the standard applied when evaluating whether a pre-suit demand has been excused in a stockholder derivative suit filed pursuant to Chancery Rule 23.1.") (internal quotations omitted); *Tyson*, 919 A.2d at 582 ("The inquiries differ, however, in the level of detail demanded of the plaintiffs' allegations and the directors at whom the inquiry is directed.")

207. *See Tyson*, 919 A.2d at 582-83 ("[S]ome defendant directors are alleged to be sufficiently entangled to be lacking independence for 12(b)(6) purposes, but would be given the benefit of the doubt under the stricter standard of Rule 23.1.").

In addition to the level of particularity required of a plaintiff, demand futility and exculpation motions are different insofar as they place the burden of persuasion on different parties. Under Rule 23.1, the burden is on the plaintiff to show demand futility. In a 12(b)(6) motion to dismiss based on an exculpation clause, the burden is placed on the defendant directors to demonstrate that there is no allegation that they failed to act in good faith.[208] In short, motions to dismiss based on exculpation clauses are not as favorable to directors as Rule 23.1 motions.[209]

Consider the conscious disregard species of good faith violations described earlier. Whether one consciously disregarded his or her duties turns, of course, on a determination about state of mind. Yet, a director's state of mind is often difficult to evaluate with any degree of confidence due to non-observability and the potential for mixed motivations.[210] These weaknesses are only exacerbated when the analysis must proceed (1) before discovery (2) under notice pleading standards when judges must decide that there are no set of facts they could infer from the well-pleaded allegations that would allow plaintiffs to prevail and (3) with the burden of proving the absence of bad faith allegations on the defendant.

Contrast this with the situation facing directors in a delegation case. Assuming an exculpatory clause and no other interest—or independence—related facts, Rule 23.1 and *Rales* require a well-pleaded allegation of the ultimate fact—that the directors *knew* they were disabling themselves from discharging their duties when they delegated the relevant decision to management.[211] Given the wide berth afforded directors with respect to delegation, that is a difficult test indeed, highlighting the importance of the

208. *Emerald Partners*, 726 A.2d at 1223-24 (describing how the burden lies with the party seeking the statute's protection).

209. In *In re Lear*, 2008 WL 4053221, at *7, Vice Chancellor Strine took the novel approach of incorporating an analysis of an exculpation clause's applicability in to a demand futility analysis under *Aronson*'s second prong. This move would solve many of the problems described in this Article. However, it is not clear that the incorporation of exculpation considerations into a second-prong analysis is consistent with Delaware law as discussed in this Part. Along this line, the two cases cited in support of the move, *Guttman* and McMillan v. Intercargo Corp., 768 A.2d 492, 501-02 (Del. Ch. 2000), are cases operating under the *Rales* framework and not *Aronson*. The Supreme Court has effectively incorporated exculpation into its analysis of *Aronson*'s second prong in the LLC context. *See* Wood v. Baum, 953 A.2d 136, 140-41 (Del. 2008). The opinion in *Wood*, however, did not explain how *Aronson*'s second prong invited any consideration of the exculpation clause, citing to *Guttman* (*Rales* case), *Stone* (*Rales* case), *Malpiede* (12(b)(6) motion), Emerald Partners v. Berlin, 787 A.2d 85 (Del. 2001) (rejecting recourse to an exculpation clause at the demand stage where entire fairness is necessarily the standard of review), and *Desimone* (*Rales* case).

210. *See, e.g.,* Einer Elhuage, *Sacrificing Corporate Profits in the Public Interest*, 80 N.Y.U. L. REV. 733, 778 (2005) (contrasting what is entailed in subjective and objective inquiries into directors' motives).

211. *See supra* note 174 and accompanying text.

demand futility test.

There is an additional distinction to be made between dismissals for failure to make demand and dismissals based on exculpatory clauses. Only directors receive the benefit of exculpation.[212] Even if a subsequent motion to dismiss insulates directors from liability, it has no effect on executive liability. When *Aronson*'s second prong is met, directors are stripped of litigation-related authority. Aside from establishing a special litigation committee, they are unable to decide whether pursuing an action against an executive is in the corporation's best interests. Even if the suit is subsequently dismissed against the directors based on an exculpation clause, the directors remain powerless to make litigation decisions regarding the suit against the executive. Thus, in the case of a due care claim against director coupled with any claim against an executive, *Aronson*'s second prong will reallocate authority to shareholder plaintiffs even if there is no potential liability for directors.[213]

VI. REVISING ARONSON

The incentives towards overdelegation outlined in Part IV can be fixed either by making *Rales* more like *Aronson* or, alternatively, by making *Aronson* more like *Rales*.[214] Taking the former scenario, assuming board delegation, courts could inquire into the existence of a valid business judgment with respect to the Original Decision by whomever other than the full board acted for the corporation—either a board committee or an employee. If there was a reason to doubt the validity of that business judgment, then demand could be excused. The *Rales* test would then provide no more protection than the *Aronson* test and directors would have no incentive to overdelegate.[215] Taking the latter scenario, assuming board action, application of *Aronson*'s second prong would simply require investigation of whether a majority of the board faced a substantial likelihood of personal liability as a result of that decision.[216] If not, perhaps because the claim is exculpated under a 102(b)(7) clause, demand would be

212. *See* DEL. CODE ANN. tit. 8 § 102(b)(7).

213. For an example of such a case, see McPadden v. Sidhu, 2008 WL 4017052 (Del. Ch. 2008). Of course, this result is not likely troubling to those who are concerned with structural bias on the part of directors in favor of executives.

214. Admittedly, one might be willing to pay the price of overdelegation if they believed that boards are less capable of responding to demands in director-action suits than those in director-non-action.

215. Indeed, that approach would likely provide directors with less protection in practicality because they would be completely reliant on another party, the delegate, to determine whether demand is futile.

216. Even more elegant would be the substitution of the test described in *Desimone*, 924 A.2d at 935-36.

required. Again, the *Rales* test would provide no more protection than the *Aronson* test and directors would have no incentive to overdelegate.

Having controlled for distorted incentives for delegation under either solution, the choice between the two comes down to one's view of board authority. As a practical matter, it is safe to say that changing *Rales* to look more like *Aronson* would be a significant departure for Delaware law. It would be hard to imagine Delaware courts letting shareholders control corporate litigation where (1) the underlying misconduct was that of an employee, (2) a majority of directors had no personal interest in the misconduct, and (3) a majority of the board did not face a substantial likelihood of personal liability based on the failure to monitor. In short, no one complains much about *Rales*.

At a more substantive level, broader applicability of *Rales* is less troublesome than broader applicability of *Aronson*. As discussed earlier, all things being equal, boards are in a better position than courts to calculate the costs and benefits of pursuing derivative litigation. The cost of excluding boards from that decision-making process when they face no threat of personal liability seems to be relatively high in comparison to the costs of leaving it up to potentially, *but not necessarily*, biased directors to pursue such actions.

The best solution, therefore, is to revise *Aronson*'s second prong. Instead of asking whether an Original Decision was the product of a valid business judgment, the operative question should be whether there is a reasonable doubt that a majority of the board faced a substantial likelihood of personal liability.[217]

217. Revising *Aronson* might also solve another issue spelled out by Vice Chancellor Strine in his law review article. *See* Leo E. Strine, *The Inescapably Empirical Foundation of the Common Law of Corporations*, 27 DEL. J. CORP. L. 499 (2002) [hereinafter *Empirical Foundation*]. The following description of the problem tracks Strine's hypothetical. *Id.* at 504-10.

Imagine a corporation, S, that has a dominant shareholder, D. D wants to transact with S. A majority of S's board are independent directors with no ties to D. The transaction is approved by the independent directors (the "dependent" directors having abstained) and S's shareholders file a derivative suit. Reconsider *Aronson*'s two prongs: disinterest/independence relating to the Original Decision and otherwise valid business judgment as to the Original Decision. Assume that the decision by the five independent directors would be considered an exercise of valid business judgment. One would expect demand to be required unless there was reason to suspect that the directors were not really independent of D under *Aronson*'s first prong.

But because D is a majority shareholder, the business judgment rule is inapplicable. *See, e.g.*, Emerald Partners v. Berlin, 787 A.2d 85, 92-93 (Del. 2001). Instead, the entire fairness test is applied. *Id.* Approval by disinterested directors merely shifts the burden of proving fairness from the directors and D to the plaintiffs. *See, e.g.*, *id.* at 95. When entire fairness is the test, how does *Aronson*'s second prong come out at the demand stage? It may be that the application of the entire fairness test automatically means failure of *Aronson*'s second prong, notwithstanding an independent, disinterested board making an informed,

VII. CONCLUSION

Aronson and its two-pronged test have undoubtedly stood the test of time. And, understandably, almost twenty-five years of seniority brings with it a degree of immunity from criticism. Nevertheless, this Article has made the case that *Aronson*, its second prong in particular, should be criticized. The second prong removes board discretion over a class of Demand Decisions that should belong to directors for all the reasons other ordinary decision-making authority rests with them. Further *Aronson*'s second prong distorts director incentives and encourages more delegation than boards would otherwise choose.

This Article does not purport to conclusively demonstrate that directors actually understand or respond to the incentives created by *Aronson*'s second prong. Indeed, interviews with practitioners lead to the conclusion that few directors consider demand futility tests when deciding whether or not to delegate. Accordingly, revising the *Aronson* test to function more like the *Rales* test may not yield significant improvement in the delegation/management balance.

Nevertheless, the revision may provide some help in that regard. Moreover, it would restore board authority in Demand Decisions over which directors should be able to judge impartially.[218] At the very least, it would make demand futility simpler and more direct—a noble goal in and of itself.

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non-wasteful decision. *See Empirical Foundation* at 508 (noting the entire fairness line of cases' "import may be to excuse demand under the second prong of *Aronson*").

The Vice Chancellor describes this as a tension between *Aronson* and the entire fairness line of cases. *Id.* at 510. Implicitly, he finds the tension being generated by the entire fairness line. But what if the problem is really with *Aronson*'s overly artificial second prong? If the demand futility test was something like the one found in *Rales*, it would be of no necessary consequence that the Original Decision was not the product of a valid business judgment. A court would simply look to find disinterest, independence, and no substantial likelihood of personal liability. If those conditions were obtained satisfactorily, demand would be required.

218. *But see supra* notes 54-55 and accompanying text (discussing non-liability-related reasons to suspect directors' impartiality as to Demand Decisions).