Inside the Boardroom: A Proposal to Delaware's Good Faith Jurisprudence to Improve Board Passivity

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Inside the Boardroom: A Proposal to Delaware’s Good Faith Jurisprudence to Improve Board Passivity

Kay Xixi Ng*

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I. INTRODUCTION

In a typical law school's introductory course on business organizations, we learn the legal relationships among three important actors of a firm: the shareholders, the board of directors, and the executives. The board as a whole constitutes the top-level manager of the firm, while the executives are the day-to-day managers of the firm. The law assumes that shareholders are the owners of a firm, that shareholders elect the board members, and that the board selects the firm's executives. Accordingly, a firm's executives are simply agents of the firm's principals, i.e., the shareholders. The board of directors stands in between the agents and the principals to closely monitor the firm's executives in order to maximize shareholders' interest.

In contrast to the corporate structure idealized in the legal world, a typical real-world publicly traded corporation often has a much different structure. A firm's executives not only are the day-to-day managers of the firm, they also behave as if they own the firm. Most often, the executives choose the candidates for the board members, and the shareholders simply ratify the executives' choice. The board does not know most of the true "owners" of the firm, i.e., the shareholders. Rather, the board remains passive most of the time, except perhaps during crisis. The board also defers to the executives' decisions, except perhaps when the firm is performing so poorly that the board has to intervene.

Obviously, there is a gap between the law's assumptions and the real-life situation for the board's role in corporate governance. The board developed its current form in modern corporations as a market response to the growing presence of these corporations in the economy. Corporate law came into existence as a legal response to corporate problems that the market does not properly cure by its own force. The legal response, however, frames its solution based on its own as-

1. See Automatic Self-Cleansing Filter Syndicate Co. v. Cunninghame, (1906) 2 Ch. 34 (A.C.) (holding that the directors are not agents but are managing partners of the corporation appointed by the shareholders); Cont'l Sec. Co. v. Belmont, 99 N.E. 138, 141 (N.Y. 1912) ("The directors are not ordinary agents...They are trustees...with the power of controlling the property...without...hindrance.").


5. See Bhagat et al., supra note 3, at 886-87.
sumptions for how the market should behave, even though these assumptions may not be how the market performs in reality.

In the market, this corporate structure consisting of these three actors developed in the early twentieth century when corporate entities grew so large in scale that they needed an enormous amount of capital, which required not just a few, but a large number of individuals to contribute. As both the size of the corporations and the number of their shareholders grew, no individual shareholder or shareholding group dominated or controlled the corporate entity. Consequently, the professional management class developed to fill the role as daily managers. The result is the separation of ownership and control. Because the owner now consists of too many diffuse individuals or groups, collective action problems have made the owner a poor monitor of the agent. The board of directors developed to fill in this monitoring gap. But, because the board is chosen by the professional managers, not by the shareholders, the board's interest has always been more aligned with the agent rather than with the principal. Ever since this structure was developed in the early twentieth century, the law has sought legal mechanisms to align the interest of the board with that of the shareholders.

The legal mechanisms that seek to reform corporate governance follow a spectrum of different assumptions and attitudes toward the role of law in this arena. On one end of the spectrum is the view that a capital market provides the necessary incentive for adequate corporate governance. Scholars under this view believe that "disciplines of the capital markets," through the threats or actualities of takeovers, would cause managers to take corrective action to improve performance." The other end of the spectrum resonates with the "race to the bottom" view of Delaware's dominance in the corporate charter market. Because scholars, under this view, believe that states' competitions for corporate charters and the associated franchise fees benefit managers and not shareholders, they argue for more federal regulations in place of the current state law for corporate governance.

6. See id.
7. Id. at 887.
8. Id. at 888; see generally Adolf A. Berle, Jr. & Gardiner C. Means, The Modern Corporation and Private Property 223-26 (1933).
recently enacted Sarbanes-Oxley Act of 2002 ("SOX"), under which Congress demanded a series of mandatory corporate governance measures, can be seen as a result of this view's advocates.

Neither end of the spectrum, however, provides a satisfactory answer to corporate governance. On one hand, "[o]nly an extraordinary optimist could believe . . . takeover activity is an efficient way to deal with the organizational deficiencies of American industries." After a century of development of the current corporate form, shareholders are still highly dissatisfied with the inadequate monitoring boards of directors have provided. The recent wave of corporate scandals has once again exposed board passivity in its monitoring role. On the other hand, excessive federal regulation, such as SOX, is unlikely to improve corporate governance but likely to cause significant inefficiency that will eventually be borne by shareholders. Therefore, state law, not the capital market alone or federal law, should continue to shape corporate governance reform. This Article argues that to re-capture the duty of regulating corporate governance from the federal government, states, especially Delaware, should reevaluate their idealized legal assumptions for the relationship between the shareholders, the board, and the executives. In order to be able to recognize the true dynamics among these three actors, courts need to expand their review of board operations. In particular, I propose that Delaware courts adopt an expansive good faith evaluation for overall board operations instead of focusing solely on the transaction that is the subject of litigation. In a transaction-focused evaluation, courts may not have sufficient facts to understand the true relationship between the directors and the executives. If courts can look beyond one board transaction, the courts are much more likely to understand if the directors adequately perform their monitoring role.

The next Part attempts to explain why the board of directors has a tendency to stay passive. The Part evaluates, in particular, one long-
standing corporate governance measure that seeks to improve board passivity: the use of an independent board of directors. Numerous studies have concluded, based on a variety of evidence, that independent directors do not improve corporate performance.¹⁵ That Part then attempts to explain why these independent directors have been largely inefficacious in their monitoring role. Three recent examples of boards’ monitoring failures, which all involved boards with a majority of independent directors, are also in that Part. Part III offers my proposal to the state law’s approach to corporate governance.¹⁶ So far, Delaware evaluates a board’s performance of its fiduciary duties only for the particular transaction in dispute. The business judgment rule largely protects directors’ decision from judicial second-guessing. In some recent cases, Delaware courts have emphasized directors’ good faith, the absence of which removes the business judgment protection. I propose that Delaware courts expand the good faith evaluation to the overall board operations instead of focusing solely on the transaction in dispute. The final Part concludes.¹⁷

II. WHY DOES THE BOARD HAVE A TENDENCY TO STAY PASSIVE AND WHY INDEPENDENT DIRECTORS DO NOT IMPROVE BOARD PASSIVITY?

In order for a board of directors to vigilantly represent shareholders’ interest and to closely monitor a firm’s executives, one “intuitive”¹⁸ solution is to fill the board with directors who are independent of the firm’s executives. For a long time, many scholars have advocated for such independent directors, also referred to as outside directors.¹⁹ An independent director is usually defined as one who has no financial interest in the firm other than the director’s retainer fee.²⁰ The assumption is that independent directors, in contrast to inside di-

¹⁵. See infra note 31.
¹⁶. See infra Part III.
¹⁷. See infra Part IV.
¹⁸. Sanjai Bhagat and Bernard Black refer to this solution as following the “conventional wisdom,” since the solution appears to be the natural choice when no one is sure what an optimal board’s structure should be like. Sanjai Bhagat & Bernard Black, The Uncertain Relationship Between Board Composition and Firm Performance, 54 Bus. Law. 921, 954 (1999).
²⁰. See, e.g., Sarbanes-Oxley Act § 301(m)(3), Pub. L. No. 107-204, 116 Stat. 745 (2002) (codified at 15 U.S.C. § 78j-1(m)(3)) (noting that to qualify as independent, the director may not “accept any consulting, advisory or other compensatory fee from the issuer” nor be an “affiliated person of the issuer or any subsidiary thereof”).
rectors, are less likely to defer to the firm's executives.21 Although the business community initially opposed to a mandate of the American Law Institute requiring independent directors, a board consisting of a majority of independent directors has become the present norm.22 But numerous studies find independent directors do not improve firm performance and that these directors have a positive influence, at best, on firms during a crisis.23

A. Academic Findings on Independent Directors' Performance

Scholars have characterized a board's functions into two categories: monitoring of a firm's day-to-day performance and intervention during crisis.24 Professor Romano terms these two categories as the strong form and the weak form of the monitoring board hypothesis.25 Under the strong form, a board with a majority of independent directors would have a continuous effect on firm performance.26 Thus, the strong form of the hypothesis predicts a positive correlation between the percentage of independent directors and firm performance.27 Under the weak form, independent directors are better than insiders to react to gross failures of a firm and to adjust the firm's strategies to correct the failure.28 Accordingly, the weak form of the hypothesis predicts a positive correlation between the percentage of independent directors and a firm's performance only during crisis.29

Numerous empirical studies based on a variety of analytical approaches have sought to measure independent directors' impact on a firm's performance.30 However, these studies have overwhelmingly

22. Id. at 282-83.
23. See infra Part II.A.
24. Romano, Corporate Law, supra note 21, at 285.
25. See id.
26. Id.
27. Id.
28. Id.
29. Romano, Corporate Law, supra note 21, at 285.
concluded that the strong form of the monitoring board hypothesis does not stand.\textsuperscript{31} Professors Romano, Bhagat, and Black, in two separate literary reviews, examined dozens of studies, which have adopted different performance measures and various types of data.\textsuperscript{32} They found that "[n]o matter what variable is used to measure performance, virtually all studies find that there is no significant relation between performance and board composition."\textsuperscript{33} Significantly, one study that adopted a definition of independent directors that yielded a higher proportion of independent directors than other studies found a significant negative relation between firm performance and board composition.\textsuperscript{34}

Studies of specific events of a firm have found some support for the weak form of the monitoring board hypothesis.\textsuperscript{35} For example, Professor Weisbach's empirical study, based on data for all 495 NYSE-listed companies between 1977 and 1980, found "firms with outsider-dominated boards [we]re significantly more likely than firms with insider-dominated boards to remove the CEO on the basis of performance."\textsuperscript{36} Professor Weisbach provides a plausible story to explain this result: "[F]ollowing poor performance, firms first respond by adding outsiders to the board. If poor performance continues, these outsiders remove the CEO."\textsuperscript{37} One separate study further found firm performance modestly improved after its CEO was replaced.\textsuperscript{38} These two studies, combined, support the hypothesis that a board dominated by independent directors improves a firm's performance following the firm's poor performance. Studies of other events are less clear-cut

\textit{The Implications of Board of Directors' Composition for Corporate Strategy and Performance, 5 INT'L J. MGMT. 229 (1988).}

\textsuperscript{31.} See Romano, \textit{Corporate Law}, supra note 21, at 284-90; see generally Bhagat & Black, \textit{supra} note 18, at 922 (reviewing a number of empirical studies and concluding that these studies show "no convincing evidence that firms with majority-independent boards perform better than firms without such boards").

\textsuperscript{32.} See Romano, \textit{Corporate Law}, \textit{supra} note 21; Bhagat & Black, \textit{supra} note 18.

\textsuperscript{33.} Romano, \textit{Corporate Law}, \textit{supra} note 21, at 287.

\textsuperscript{34.} Anup Agrawal & Charles R. Knoeber, \textit{Firm Performance and Mechanisms to Control Agency Problems Between Managers and Shareholders, 31 J. FIN. & QUANT. ANALYSIS 377 (1996).} The study examines the relationship between performance and seven types of control mechanisms a firm generally adopts. \textit{Id.} Except for board composition, the firms under research have used optimal use of each of the six control mechanisms. \textit{Id.} For board composition, the study finds that more outside directors have a negative effect on performance, indicating that firms have chosen too many outside directors. \textit{Id.}

\textsuperscript{35.} See Romano, \textit{Corporate Law}, \textit{supra} note 21, at 290; Bhagat & Black, \textit{supra} note 18, at 923-40.

\textsuperscript{36.} Weisbach, \textit{supra} note 4, at 432.

\textsuperscript{37.} \textit{Id.} at 454.

\textsuperscript{38.} See David J. Denis & Diane K. Denis, \textit{Performance Changes Following Top Management Dismissals, 50 J. FIN. 1029, 1055 (1995).}
than is the study of the scenarios of a poor-performing CEO. For example, although some studies found evidence that target firms with majority-independent boards extract higher prices from bidders than insider-dominated boards, the studies do not tell us whether majority-independent boards produce better outcomes for shareholders of potential targets.\textsuperscript{39} Further, according to Professors Bhagat and Black, the evidence does not strongly indicate whether independent boards behave significantly more (or less) shareholder-friendly than other boards in terms of adopting takeover defenses.\textsuperscript{40} On the other hand, Professor Romano cites some studies that found a positive stock price movement after a firm adopted a poison pill if outsiders dominated the firm’s board, but they found a negative price movement if insiders dominated the firm’s board.\textsuperscript{41} Taken as a whole, these empirical studies show that independent boards provide better monitoring for certain types of events, such as firing of the CEO following poor performance, but less certain results for other events.

Besides measuring directly the correlation between a firm’s performance and its board composition, other studies sought to account for the effect of board composition from other angles.\textsuperscript{42} After all, the business world is far more complex than the simple dichotomy of the weak and strong forms of the hypothesis.\textsuperscript{43} For example, a study complied by Gillan and others found different types of firms choose distinctly different approaches to governance choices, implying that different firms require different board structures.\textsuperscript{44} Furthermore, April Klein found that different board committees required different board composition; significantly, she found that insider presence on finance and investment committees improved firm performance.\textsuperscript{45} These two studies suggest that inside directors provide valuable contribution to a firm’s performance because different industries and firms may have varying degrees of agency costs. Accordingly, they require different levels of monitoring from the board.\textsuperscript{46} Moreover, dif-

\textsuperscript{39} Bhagat & Black, supra note 18, at 928-29.
\textsuperscript{40} Id. at 929-30.
\textsuperscript{41} Romano, Corporate Law, supra note 21, at 292-93.
\textsuperscript{43} Romano, Corporate Law, supra note 21, at 285.
\textsuperscript{44} See Gillan et al., supra note 42, at *1.
\textsuperscript{45} Klein, supra note 42, at 287-301.
\textsuperscript{46} Gillan et al. reason that the costs and benefits of monitoring agency problems differ across firms and industries. Gillan et al., supra note 42, at *1. Accordingly, firms with high agency costs require more powerful boards than firms with low agency costs. Id.
Different industries may require different sets of knowledge and information from the directors. Thus, a firm may need more insider directors, who tend to have a deeper understanding about the firm than outsider directors, when the firm requires sophisticated guidance regarding unique industry practices.

Finally, the dichotomy between insiders and outsiders may become blurred over time. Professors Hermalin and Weisbach developed a model to show that board independence declines over the course of a CEO's tenure, even though the same independent board composition stays throughout this period. Professors Hermalin and Weisbach quote a leading venture capitalist for this phenomenon: "At the end of the day, most independent directors get neutralized in one fashion or another."

B. Explaining These Academic Findings

The consistent findings that independent boards do not improve performance except, perhaps, during crisis may seem to be counterintuitive. After all, independent directors are supposed to be better guards for shareholders' interest against executives' abuses because independent directors are, by definition, not subject to the executives' control. However, the consistency of the empirical studies suggests that factors other than independence affect a board's proper monitoring role. This Section seeks to explain why boards often fail to provide the necessary monitoring desired by shareholders. This Section first examines characteristics associated with boards in general that tend to adversely affect their monitoring abilities or incentives. This Section then examines these characteristics for boards dominated by independent directors and explains why these boards do not perform a better monitoring job except during crisis.

1. Boards in General

At the outset, directors have their own conflict of interest in performing their monitoring role. Unless a firm has a dominant shareholder who selects its share of directors, most directors are chosen not by shareholders, but by the firm's executives. As a legal matter, a

47. "[I]nternal managers contribute 'valuable specific information about the organization's activities.'" Klein, supra note 42, at 277 (quoting Eugene F. Fama & Michael C. Jensen, Separation of Ownership and Control, 26 J. Law & Econ. 301, 304 (1983)).

48. See Hermalin & Weisbach, supra note 2, at 111-12.

49. Id. at 111 (quoting Smale et al., Redraw the Line Between the Board and the CEO, HARV. BUS. REV., Mar./Apr. 1995, at 158).

50. Id. at 96; Bhagat et al., supra note 3, at 887.
director should represent the shareholders' interest. In reality, because the executives largely determine those who serve as the company's directors, these directors have a natural tendency to be more loyal to their appointing party than to their legal constituency. A director gains both monetary compensation in the form of retainer fees and reputational enhancement by sitting on a company's board. If the business world knows a person is likely to be a strong shareholders' advocate and tough to the executives, the executives are simply less likely to choose this person as a director candidate.

More importantly, a firm's directors face the same collective action problem as faced by a large firm's dispersed shareholders. In law and often in academic studies, we assume that the board is a monolithic entity. But instead, the board is composed of individuals. When there are individuals in a group, collective action problems exist if each member's pro rata share of the benefit from a particular action is less than the cost for the individual member. This mismatch of benefit and cost is often the case for the board of directors except, perhaps, during crisis. The relatively remote benefit to most directors for monitoring is slight compared with the high cost to each of the individual directors. Three factors contribute to this mismatch: the board's non-hierarchical structure, the incentive structure for the directors, and the board's large size.

Directors are mostly of equal status on the board, unlike a firm's executives who receive all of the praise and are fully accountable and responsible for their particular group's performance. Directors often serve on a board either because of their historical contribution to the firm or because of their expertise or reputation in a particular field. Although many directors are also shareholders of the firm, they do not necessarily have to own shares. As a result, the benefit to an individual director for monitoring is the reputational gain, often slight and remote, when monitoring improves the firm's performance. The cost of monitoring to an individual director, by contrast, could be significant. As discussed above, directors often owe their job to the execu-

52. See Bhagat et al., supra note 3, at 887.
53. See id. at 890-91.
55. Id.
56. See Bhagat et al., supra note 3, at 887-88.
57. Id.
58. Hermalin & Weisbach, supra note 54, at 22 n.2.
If an individual director is perceived as being aggressive to the executives, the director may lose the job, the associated retainer fee, and the reputational enhancement. On the other hand, if the firm performs poorly, each individual director only bears a small portion of the blame because all the directors on the board share the responsibility equally. Perhaps only when the firm experiences a crisis, the proportionate reputational cost to an individual director justifies that he or she begins to monitor actively.

The incentive structure for the board of directors further aggravates the collective action problem. Board directors, in general, have limited time dedicated to monitor. They only work part time, and they do not get paid based on the number of hours they work. Each director is often paid a fixed annual retainer fee for the director's role. Firms also compensate directors for attending meetings or participating in special committees. However, the board usually assigns the number of meetings and committees ahead of time. Accordingly, at the beginning of a fiscal year, each director knows relatively certain her compensation, irrespective of how much additional time the director needs to spend. Suppose a member of the board desires to monitor the executives more closely than others. Because the incentive structure does not award the director based on her performance or extra effort, over time this director's motivation will likely dwindle.

The large size of most firms' boards is another major contributor to the collective action problem. Many scholars have suggested that boards are too large and recommended that firms reduce the board size. Empirical studies consistently find that board size is negatively correlated with firm performance: the larger the board, the less likely an individual director needs to take the blame for the firm's poor performance. Further, as a group's size increases, its coordination and processing skills diminish. Therefore, the larger the board, the more severe of the collective action problem is within the board, and the less the board monitors the executives.

59. Bhagat et al., supra note 3, at 887-88; see Hermalin & Weisbach, supra note 54, at 10.
60. See Lipton & Lorsch, supra note 9, at 64.
62. See, e.g., In re Walt Disney Co. Derivative Litig. (Disney I), 731 A.2d 342, 355 (Del. Ch. 1998).
63. 2 FLETCHER CYCLOPEDIA OF THE LAW OF CORPORATIONS § 398 (2007).
64. See, e.g., Bhagat & Black, supra note 18, at 941-42; Lipton & Lorsch, supra note 9, at 65.
65. See Bhagat & Black, supra note 18, at 941-42; see also April Klein, Economic Determinants of Audit Committee Independence, 77 ACCT. REV. 435, 438 (2002).
66. See Lipton & Lorsch, supra note 9, at 65; see also Klein, supra note 42.
Besides the conflict of interest and collective action problems faced by a board, executives' strong incentive to entrench the board further explains board passivity. Executives, for honorable or non-charitable reasons, wish to receive the trust of the board so that the board will challenge the executives' decisions as little as possible. When a firm's performance is good on paper, the board has little incentive or reason to challenge the executives. As a result, the board, shaped by the executives, gradually develops into a harmonious atmosphere where the board significantly defers to the executives and accepts whatever the executives inform them. Thus, even if the executives lie or commit fraud in order to present a rosy picture for the firm, the board is unlikely to step in because the board can hardly detect the fraud. Only when a firm's performance is poor on paper does the board have any reason to intervene. Professors Hermalin and Weisbach phrase the situation: "The more entrenched the CEO is, the less intensely he is monitored."67

When all three factors faced by a board—conflict of interest, collective action problem, and executives' entrenchment tendency—are combined, it is understandable why boards do not monitor as much as shareholders desire. Perhaps the strongest incentive for a board to monitor is the potential of a shareholders' lawsuit against the board for breach of its fiduciary duty. Yet the current business judgment rule under state law and the availability of a director's or officer's liability insurance largely insulate each director from personal liability and, thus, reduce the board's incentive to monitor.

2. Boards with a Majority of Independent Directors

Independent directors still face the same conflict of interest and collective action problems. Proponents of independent boards had probably thought that independent directors would face less conflict of interest issues than insider directors; independent directors do not work with the executives on a daily basis and do not report to the CEO. But, in reality, an outsider becomes a director often because the CEO has chosen the outsider on the nomination slate. Thus, most independent directors still owe to the CEO for their jobs. This personal loyalty to the CEO reduces an independent director's incentive to zealously represent shareholders who are, after all, most likely strangers to the director.

In some sense, the collective action problem is even worse for independent directors than insider directors because the benefit of moni-

67. Hermalin & Weisbach, supra note 2, at 108.
toring to an independent director is lower than insider directors, but the cost of monitoring is higher. Unless an independent director is also a shareholder, the independent director, by definition, receives no financial interest in the firm other than the director's retainer fee. In contrast, an insider director has a much stronger financial interest in the firm's performance. An insider may receive bonuses tied to the firm's performance or promotions because of the insider's extraordinary service as an executive. However, neither bonus nor promotion is available to an independent director. Moreover, independent directors must spend more effort than insider directors to get to know the firm, but the compensation structure does not award the independent director's extra effort. If a firm's business requires its directors to understand peculiar insider information specific to the firm, the firm may require more insiders than independent directors. This explains Gillan's finding that different firms require different insider/outsider compositions.

Perhaps only with regard to the executives' entrenchment independent directors may perform better than insider directors. Independent directors are usually less familiar with the firm's executives than insiders. Accordingly, they are better than insiders to resist the CEO's entrenchment tendency. But it is only a matter of time before independent directors are unable to resist this tendency. Thus, unless the independent directors are recently added to the board, the long-tenured independent directors are probably just as passive as the inside directors. This explains why firms tend to increase independent directors during times of poor performance. New faces in the boardroom are less loyal to the firm's executives, more likely to break the harmonious atmosphere, and more prone to challenge the executives. Thus, they are more likely to remove the CEO for a poor performance.

C. Three Recent Examples of Boards' Monitoring Failures

This Section describes three recent and prominent examples of boards' monitoring failures, and, in all three examples, the boards had a majority of independent directors. The Disney board's poor decision

68. See supra note 20 and accompanying text.
69. See Gillan et al., supra note 42, at *25-*26; see supra note 44 and accompanying text.
70. Because independent directors, unlike inside directors, are not full-time employees, independent directors are also less familiar with the executives.
71. See supra note 49 and accompanying text.
72. Actors other than the executives must be responsible for making this change during a crisis. We don't expect an executive to add a slate of directors who will later remove this executive. But who the responsible actors are is less clear. Perhaps during a crisis, strong market forces lead some dominant shareholders to set up.
to hire Michael Ovitz received significant media attention and resulted in costly shareholders' lawsuits. Because the WorldCom board was passive and overwhelmed by the dominant CEO, the board remained ignorant while the CEO conducted massive frauds. The Enron board possessed all the "model" characteristics recommended by the business world. Yet, it still failed to challenge any of the questionable accounting schemes that the executives had proposed. The failure of the WorldCom and Enron boards' monitoring led a panicked Congress to enact SOX, which required all publicly traded companies to have audit committees composed of independent directors. But independent directors already dominated both the WorldCom and the Enron boards when the wrongdoings occurred, leaving us to wonder what positive effect SOX will achieve.

1. Walt Disney Company

The Walt Disney Company's controversy involved the hiring and firing of Michael Ovitz as Disney's president. In October 1995, Michael Ovitz and Disney entered into an employment agreement under which Ovitz would serve as Disney's president for five years.\(^{73}\) Ovitz only served the position for slightly over one year before Disney terminated Ovitz in December 1996.\(^{74}\) But, under the terms of the employment agreement, Disney paid Ovitz a total severance payout valued at approximately $130 million.\(^{75}\) In January 1997, several Disney shareholders quickly brought derivative actions in the Delaware Court of Chancery.\(^{76}\) One central claim of these shareholders' lawsuits was that the Disney board of directors breached its fiduciary duty to the shareholders when the board inattentively approved the employment agreement with Ovitz.\(^{77}\) These litigations lasted for ten years, and the Supreme Court of Delaware affirmed in June 2006 the Chancery Court's judgment in favor of Disney's board.\(^{78}\) Although two of Disney's largest individual shareholders supported the hiring decision,\(^{79}\) the litigations exposed how a major American corporation's board "ordinarily" performs its monitoring role on behalf of the shareholders, even though the majority of the board's directors were independent.

74. *Id.*
75. *In re* Walt Disney Co. Derivative Litig. (*Disney III*), 906 A.2d 27, 35 (Del. 2006).
76. *Id.*
77. *Id.*
78. *Id.* at 75.
79. *See id.* at 36 n.4, 39 n.10 (Roy Disney and Sid Bass were the two large shareholders who supported the hiring decision).
In approving the hiring of Ovitz and the employment agreement, Disney’s board basically followed all of the directions of Michael Eisner, Disney’s then-CEO for over ten years. After Disney lost its former president in a tragic helicopter crash, Eisner began to search for a successor. 80 His primary candidate for the position was Ovitz, with whom Eisner had enjoyed a social and professional relationship for nearly twenty-five years. 81 Initially, Eisner expressed his desire to hire Ovitz with the board members on an individual basis. 82 Under Disney’s charter, the board was responsible for selecting the corporation’s officers, and a compensation committee was responsible for establishing and approving salaries for the officers. 83 Disney’s board was composed of fifteen members at that time, eleven of whom qualified as independent directors. 84 Accordingly, both the board and the compensation committee were composed of a majority of independent directors. The non-independent compensation committee member was Irwin E. Russell, who was also Eisner’s personal attorney. 85 Eisner and Russell were primarily responsible for negotiating the terms of the employment agreement with Ovitz. 86 They later brought in one of the three independent compensation committee members, Raymond Watson, to evaluate a proposed compensation package for Ovitz. 87 After these members reached an agreement with Ovitz, they contacted the rest of the two compensation committee members by phone in order to inform them of the hiring decision and the terms of the employment agreement. 88 Eisner also informed each of the remaining board members by phone. 89 The

80. *Disney III*, 906 A.2d at 36.
81. Id.
82. Id.
83. Id. at 53.
84. *See In re Walt Disney Co. Derivative Litig. (Disney I)*, 731 A.2d 342, 356-61 (Del. Ch. 1998). The Delaware Chancery Court considered a director to be independent if that director can exercise his or her business judgment independent of the CEO’s influence. Id. According to this definition, the court concluded that twelve of the directors were independent. Id. But one of these twelve directors, Roy E. Disney, was also a top executive at Disney. Id. Accordingly, when an independent director is defined as “one who has no financial interest in the firm other than the director’s retainer fee,” Roy E. Disney does not qualify as an independent director. Id.
85. *See Disney III*, 906 A.2d at 40 (describing the names of the compensation committee’s four members); *Disney I*, 731 A.2d at 360-61 (one of the compensation committee’s members was Eisner’s personal counsel and was not considered an independent director; the court concluded that the other three members all qualified as independent).
86. *Disney I*, 731 A.2d at 360-61.
88. Id. at 38.
89. Id. at 39.
90. Id.
compensation committee then formally approved the employment agreement in its one-hour meeting, during which the committee also considered other agendas.\textsuperscript{91} Each committee member received a term sheet at this meeting, but not a draft of the employment agreement.\textsuperscript{92} Immediately after the compensation committee meeting, the Disney board met.\textsuperscript{93} Eisner led the discussion regarding Ovitz, and Watson and Russell responded to questions from the rest of the board.\textsuperscript{94} The board then formally voted unanimously to elect Ovitz as Disney’s new President.\textsuperscript{95}

Ovitz’s tenure at Disney was brief. In September and November 1996, Eisner informed the board during board meetings of the continuing problems with Ovitz’s performance.\textsuperscript{96} Around the same time, Eisner worked with Disney’s general counsel to consider whether Disney could dismiss Ovitz for cause, in which case Disney would not be obligated to pay the $130 million severance to Ovitz under the employment agreement.\textsuperscript{97} But Eisner and the general counsel found that they could not dismiss Ovitz for cause.\textsuperscript{98} Eisner then announced Ovitz’s termination to the public through a press release.\textsuperscript{99} Before the press release was issued, Eisner attempted to inform each of the board members by telephone of the decision.\textsuperscript{100} None of the board members objected to Ovitz’s termination.\textsuperscript{101} According to the Chancery Court:

\begin{quote}
Although the board did not meet to vote on the termination, ... most, if not all, of the Disney directors trusted Eisner’s and [the general counsel’s] conclusion that there was no cause to terminate Ovitz, and that Ovitz should be terminated without cause even though that involved making the costly [severance] payment.\textsuperscript{102}
\end{quote}

Disney’s shareholders who brought the lawsuits unsuccessfully argued that the compensation committee members breached their fiduciary duty by approving the employment agreement with Ovitz.\textsuperscript{103} The Delaware court reviewed the board’s decision under the business judgment standard.\textsuperscript{104} Under this standard, “the law presumes that ‘in

\textsuperscript{91} Id. at 40.
\textsuperscript{92} Disney III, 906 A.2d at 40.
\textsuperscript{93} Id. at 41.
\textsuperscript{94} Id.
\textsuperscript{95} Id.
\textsuperscript{96} Id. at 43-44.
\textsuperscript{97} Disney III, 906 A.2d at 43-44.
\textsuperscript{98} Id.
\textsuperscript{99} Id. at 45.
\textsuperscript{100} Id.
\textsuperscript{101} Id.
\textsuperscript{102} Disney III, 906 A.2d at 43-44.
\textsuperscript{103} Id. at 51-52, 61-62.
\textsuperscript{104} Id. at 52.
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.”

A plaintiff can rebut the presumption if “the plaintiff shows that the directors breached their fiduciary duty of care or of loyalty or acted in bad faith.” The court adopted a gross negligence standard for the duty of care determination. Although the court acknowledged that, in approving the terms of the employment agreement, the compensation committee did not follow the “best practices,” the court refused to find that the compensation committee acted in gross negligence. According to the court, even though not every member of the committee reviewed the draft of the employment agreement, each member was informed of the substance of the agreement either orally through other members or through the term sheet. Thus, because “the committee had adequately informed itself of the potential magnitude of the entire severance package,” the committee had not breached its duty of care. Because the shareholders also unsuccessfully argued that the committee members had acted in bad faith and did not argue that the members had breached their duty of loyalty, the compensation committee’s decision was protected under the business judgment standard.

The shareholders' challenge to the board's hiring decision was similarly unsuccessful. According to the court, because the directors were informed of all the information reasonably available concerning Ovitz's hiring, the directors were not grossly negligent in approving the hire.

Perhaps the hiring decision was in fact an unfortunate mismatch between Ovitz and Disney, not the result of the board's negligence. Nevertheless, the Disney litigations provide for us a valuable insider look into the operations of a major American corporation's board, a board

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105. Id. at 45 (citing Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984)).
106. Id. at 52.
108. Id. at 697, 760; see also Disney III, 906 A.2d at 58.
110. Id. at 58.
111. Id. at 62. In making the bad faith determination, the Delaware Supreme Court approved the Chancery's definition of bad faith. Under this definition, the "intentional dereliction of duty, a conscious disregard for one's responsibilities, is an appropriate (although not the only) standard for determining whether fiduciaries have acted in good faith." Id.
112. See id. at 58.
113. Id. at 61-62, 67-68.
with a majority of independent directors. Michael Eisner, the CEO, was the driving force for the hiring decision and negotiations concerning the employment agreement. Once Eisner made up his mind, he only had to contact the rest of the board members individually through telephone to secure their support. Once Eisner had informed these board members by phone, both the compensation committee's formal approval and the board's formal unanimous vote were exceedingly brief. But the business judgment standard protects a board's decision from judicial scrutiny as long as the board members made an informed decision. The board adequately informed itself, according to the Delaware court, even though the executives brought the information informally to the board and the board never even deliberated the information.

Moreover, the Disney board's composition confirms the academic findings that the executives often choose the board members, including independent board members. As discussed above, at the time when the board approved to hire Ovitz, eleven of the board's fifteen members qualified as independent directors. Of these eleven independent directors, the Delaware court cited at least five that had maintained personal relationships with Eisner outside of their directorship: two were Disney's retired executives; one was the president of Georgetown University, which had received over one million dollars in donations from Eisner; one was counsel to a law firm retained by Disney; and one was the principal of the elementary school where Eisner's children had attended. Through these relationships, we can understand how these directors could have paid natural deference to Eisner.

2. WorldCom

WorldCom's accounting scandal in 2002 shocked the world and led to major changes in accounting, business, and legal communities. Unlike the Enron scandal discussed below, WorldCom, under the leadership of its then CEO, Bernard Ebbers, had engaged in outright fraud.

115. Id. at 36.
116. Id. at 39.
117. Id. at 40-41.
118. See supra note 110 and accompanying text.
120. See supra note 84 and accompanying text.
122. Id. at 359.
123. Id. at 360.
124. Id. at 359.
from 1999 to 2002. It underreported its major costs by capitalizing these costs instead of expensing them. It also inflated revenues with bogus accounting entries. Overall, WorldCom had inflated its total assets by approximately eleven billion dollars through fraud. Although these frauds lasted for over three years, WorldCom's board of directors appeared to have been completely ignorant of the fraud.

The ignorance of WorldCom's board was due to the board's passivity and the strong dominance of Ebbers over the board. Ebbers co-founded WorldCom's predecessor in 1983 and grew WorldCom through a series of acquisitions in the 1990s. During most of the period when WorldCom committed frauds, the board had fifteen members. Except for Ebbers and Scott Sullivan, WorldCom's then-CFO, the rest of the thirteen members all qualified as independent directors. Almost all of these thirteen independent directors were individuals who had been owners, officers, or directors of companies WorldCom had acquired in the past. These WorldCom directors received both cash and stock options, with overall compensation heavily weighted toward the latter. For cash compensation, the directors received a fixed annual retainer fee of $35,000, plus fees for each board or committee meeting attended. Besides stock option compensation, many directors owned significant amounts of WorldCom stock because these directors had held substantial stakes in companies acquired by WorldCom. The board conducted most of its functions as a formality. It held regular meetings between four and six times a year and special meetings as needed. The meetings followed a consistent format, and Ebbers dominated all the meetings. Each meeting opened with a prayer followed by a series of presentations. Then the chairman of each special committee reported on its committee issues.

126. Id. at 9-13.
127. Id. at 13-16.
129. WorldCom Report, supra note 125, at 29.
130. Id. 265.
131. Id. at 264-65.
132. Id. at 266.
133. Id.
134. WorldCom Report, supra note 125, at 267.
135. Id.
136. Id.
137. Id.
138. Id.
The meetings discussed financial matters at high level. But, according to the Special Investigative Committee of the Board of Directors of WorldCom,—formed by WorldCom’s new board after the scandal—these high-level discussions of financial matters were consistent with the practice of most boards during the same period. Each of the special committees apparently adopted a “hand-off” approach to their commitments, largely adopting recommendations by Ebbers. The Special Investigative Committee summarized the board’s role as the following:

The Board of Directors does not appear to have known of the fraud, nor did it receive information we believe should have put it on notice. However, the Board was so passive and reliant on Ebbers and Sullivan that it had little opportunity to learn of the fraud.

The outside Directors had little or no involvement in the Company’s business other than through attendance at Board meetings.

[They] had virtually no interaction with Company operational or financial employees other than during the presentations they heard at meetings. While in this respect the Directors were far from unique among directors of large corporations, this lack of contact meant that they had little sense of the culture within the Company, or awareness of issues other than those brought to them by a few senior managers.

Ebbers was autocratic in his dealings with the Board, and the Board permitted it. With limited exceptions, the members of the Board were reluctant to challenge Ebbers even when they disagreed with him. They, like most observers, were impressed with the Company’s growth and Ebbers’ reputation, although they were in some cases mystified or perplexed by his style. This was Ebbers’ company.

While WorldCom’s accounting fraud may have been one of the few unfortunate incidences among the country’s numerous corporations, WorldCom board’s passivity in performing its monitoring role is far from unique, as the Special Investigative Committee’s report frequently noted. But for the general norm requiring a board of directors, WorldCom may not have even needed a board. After all, the board appeared to have provided no value to the corporation or to the

139. WORLDCOM REPORT, supra note 125, at 267-68.
140. See id. at 272.
141. Id. at 7, 30-32.
142. See, e.g., id. at 31, 267-68, 290.
shareholders; instead, it caused the corporation to spend money on its valueless formality.

3. Enron

Enron's accounting scandal sent similar shockwaves throughout the world. Unlike WorldCom's outright accounting fraud, Enron engaged in a series of convoluted and questionable high-risk accounting practices to conceal its debts and to boost its assets. While WorldCom's fraud had caused its demise, it is not clear whether the fraud had caused Enron's demise or whether Enron's aggressive business model had caused its fraud. In the 1990s, Enron had transitioned from a traditional energy company with pipelines and power plants to a high-tech enterprise that traded energy contracts. Trading energy contracts exposed Enron's assets to risk fluctuations. In order to avoid the fluctuations from affecting Enron's credit rating, Enron established a series of affiliated companies to own its debts. But Enron owned less than 50% of these entities so it would not need to consolidate these entities' books. By 2000, Enron had lodged $27 billion debts in these unconsolidated affiliates. Also unlike the WorldCom fraud, of which the WorldCom board appeared to be ignorant, the Enron board was aware of and approved these accounting schemes, even though the board members claimed that they did not consider the schemes to be fraudulent. According to several of Enron's directors, they knew "the company was engaged in high-risk and innovative transactions" and "Enron was engaged in complex accounting and was operating in areas with few established accounting guidelines." Thus, because the directors thought that Enron "was engaged in business transactions that had 'not been done by many companies in the

145. Id. at 7-8; Enron Investigation, supra note 143, at 36.
146. Enron Investigation, supra note 143, at 5. Enron engaged in a number of transactions involving an accounting structure known as a special purpose entity ("SPE"). Id. A company that does business with an SPE may treat the SPE as an outside entity for accounting purposes. Id. To qualify as an SPE, an independent owner must exercise control over the SPE, i.e., owning more than 50% of the voting stock of the SPE. Id.
147. Enron Board Role, supra note 144, at 8.
148. See id. at 8, 14-24.
149. Id. at 19-20.
world’ and were ‘relatively new,’” they did not consider the accounting schemes to be questionable.\footnote{150}{Id. at 20 (quoting Lord Wakeham).}

Superficially, Enron’s board maintained a number of practices that a Delaware court would consider to be “best practices.”\footnote{151}{See supra Part II.C.1.} It had fifteen members, many of whom served on the boards of other companies.\footnote{152}{ENRON BOARD ROLE, supra note 144, at 8.} Former Chairman of Enron’s Executive Committee described members of the board as well-educated, “experienced, successful businessmen and women” and “experts in areas of finance and accounting.”\footnote{153}{Id. Only one of the fifteen board members was a woman. See id. at 1.} One of the directors was a former dean and an accounting professor at the Stanford Business School.\footnote{154}{Id. at 2.} All of the directors described internal board relations as harmonious.\footnote{155}{Id. at 8.} They could recall only two instances over the course of many years when board votes were not unanimous.\footnote{156}{Id.} They also described a good working relationship with Enron management because the directors possessed great respect for senior Enron officers, trusting the integrity and competency of the officers who were later indicted.\footnote{157}{Id. The board was organized into five committees.\footnote{158}{ENRON BOARD ROLE, supra note 144, at 8.} One of the committees was the Audit and Compliance Committee, which reviewed Enron’s accounting and compliance programs and approved Enron’s financial statements and reports.\footnote{159}{Id. at 9.} The board normally held five regular meetings per year, with additional special meetings as needed.\footnote{160}{Id. Each board meeting usually lasted two days, during which the committees also held meetings.\footnote{161}{Id. During the committee meetings, Enron management generally provided presentations on a variety of company issues.\footnote{162}{Id. Enron also organized trips abroad during which board members viewed company assets and operations.\footnote{163}{Id. But overall, the board members maintained a routine contact with less than a dozen senior officers at Enron.\footnote{164}{Id. Each board member was compensated with cash and stock.\footnote{165}{Id. The total cash and equity compensation of Enron board members in 2000}...}}}}}
was about $350,000, more than twice the national average for board compensation at a U.S. publicly traded corporation.\textsuperscript{166}

Unlike the WorldCom board, which had a strong CEO who often intimidated the rest of the board, Enron's board did not appear to have had such a dominant figure. But, at the end of the day, the board relied on what the executives informed them of, relied on the perceived "integrity" and "competence" of the executives, and relied on the "clean" audit opinions from Enron's auditor, Arthur Andersen.\textsuperscript{167}

The U.S. Senate's Subcommittee found extensive evidence showing the board was aware that Enron was engaged in questionable accounting practices.\textsuperscript{168} But Enron directors apparently never challenged the executives' decisions even when the directors received alarming information.\textsuperscript{169} For example, when Enron created a series of special purpose entities to own Enron's debts, Enron had to have "unaffiliated" people to own these entities.\textsuperscript{170} Instead of finding a truly independent investor, Enron's CFO or the CFO's subordinates owned the entities.\textsuperscript{171} Even though each entity involved hundreds of millions of dollars of Enron's investment, the directors did not feel troubled by the conflicts of interest posed because they relied on the executives to develop and implement the day-to-day controls.\textsuperscript{172} The directors were satisfied with their infrequent and generalized reviews about these entities, guided by the executives' presentations.\textsuperscript{173} After one of the special entities had operated for more than one year, the Compensation Committee sought to review the CFO's compensation from the special entity.\textsuperscript{174} The Chairman of the Compensation Committee requested this information from Enron's senior compensation officer, but the officer failed to deliver for more than one year, until the Wall Street Journal published the compensation.\textsuperscript{175} During this one year, no other board member took steps to obtain the information.\textsuperscript{176}

Not only did the Enron board rely on the executives, they probably also relied on each other. The board's large size filled with highly experienced business people aggravated the collective action problem. Perhaps each of them thought the following: "If Famous Person One

\begin{footnotes}
\item[166] Id.
\item[167] \textit{Enron Board Role}, supra note 144, at 8, 14, 24.
\item[168] Id. at 8, 14-24.
\item[169] See id at 26-29.
\item[170] See supra note 146.
\item[171] \textit{Enron Board Role}, supra note 144, at 24.
\item[172] Id. at 29.
\item[173] Id.
\item[174] Id. at 34.
\item[175] Id. at 35.
\item[176] \textit{Enron Board Role}, supra note 144, at 35.
\end{footnotes}
is not challenging the transaction, why should I be concerned and break the harmonious atmosphere that has long existed in the boardroom?" A large board filled with highly paid and highly successful people may have appeared impressive to the outside world, but, in reality, may have been a detriment to shareholders. Such a prestigious board not only costs significantly more money to maintain but is also much more inefficient to operate. The board probably did not contribute to Enron’s initial success since Enron’s executives probably created Enron’s business models. In this sense, the board’s sophistication may have simply been a façade, constructed with a hefty price to conceal its true uselessness. The five separate committees within the board all had fancy names.177 But, if all they did was passively approve of the executives’ proposals, a board may have performed far more superiorly if it had only three ordinary business people, instead of highly successful ones. Suppose board jobs for publicly traded corporations do not belong exclusively to a small community of elite members, and ordinary workers would compete based on their abilities and dedication in order to serve on a board. This open competition for board jobs would be more likely to produce more efficient and active boards.

III. Suggestions for the State Law to Improve Boards’ Monitoring

According to Professors Bhagat, Carey, and Elson, Delaware courts’ decisions favoring independent and disinterested directors “have led not to more effective management oversight but, instead, to a classic triumph of form over function – where, although prescribed procedure has been followed, decisionmaking appears to be little more than staged play-acting, absent critical engaged oversight.”178 Boards of directors at Disney, WorldCom, Enron, and countless others have confirmed these professors’ statement. Court reviews of challenged corporate decisions in Delaware have generally focused on a narrow set of transactions and sought to require boards to adopt procedural safeguards only for these transactions.179 Because of this focus on certain transactions instead of on the broader board opera-

177. See id. at 9. The Enron Board had five committees: the Executive Committee, the Finance Committee, the Audit and Compliance Committee, the Compensation Committee, and the Nominating Committee. Id.
178. Bhagat et al., supra note 3, at 918.
179. These transactions generally involve situations that are prone to potential conflicts between the board and shareholders. Examples are self-dealing transactions, transactions involving a controlling shareholder and the corporation, transactions concerning director or management compensation, and merger and acquisition transactions. See generally William T. Allen &
tion in general, Delaware law has not been effective at improving board passivity. Instead, boards react with costly procedures only to circumvent the court's scrutiny for this narrow set of transactions. On the other hand, federal encroachment into state law, such as the SOX legislation, not only has no positive effect in corporate boards but also intrudes into an area of state law whose flexibility has been one of American law's geniuses. This Part briefly summarizes why the SOX legislation is unlikely to bring positive changes to the boardroom. It then proposes that the Delaware courts continue their current wave of enhancing the good faith jurisprudence by applying the doctrine broadly to the general board operation instead of focusing solely on the particular board transaction that's the subject of litigation.

A. Sarbanes-Oxley Act: Costly but Fruitless Federal Legislation

Partly because of the inadequate safeguarding provided by state law, the federal government, in response to the market outcry over Enron, WorldCom, and a series of other large corporate scandals, hurried in and produced SOX. But, as Professor Romano convincingly argued, the procedure imposed by SOX is unlikely to bring any positive effect for corporate governance. A central mandate of SOX is all publicly traded companies must have audit committees composed entirely of independent directors. Such an independent audit committee is unlikely to be effective, but it is likely to be extremely costly. Professor Romano summarized in her article a large number of literature examining the impact of the audit committee's independence on firm performance and on financial statement misconduct. The compelling conclusion from this literature is that requiring audit committees to consist solely of independent directors will not reduce the probability of financial statement wrongdoing or improve firm performance. The discussion in Section II.B and the Disney, WorldCom, and Enron examples help explain why audit committees with solely independent directors will not achieve what Congress intended. Arguments in

180. See Romano, Corporate Law, supra note 21, at 313.
181. Romano, Sarbanes-Oxley, supra note 13, at 1523.
182. Id. at 1529-43.
184. Romano, Sarbanes-Oxley, supra note 13, at 1530-33.
185. Id. at 1533.
favor of independent directors assume that these directors are less likely to defer to the executives and, accordingly, more likely to find out wrongdoings and provide more monitoring than inside directors. But WorldCom and Enron’s boards failed to adequately monitor the executives not because the directors were not independent, but because directors have a natural tendency to stay passive and to defer to the executives’ decisions. Independent directors, contrary to what Congress wants to believe, are actually more likely to stay passive than inside directors. They are not full-time corporate employees and most likely do not depend on the corporation’s success for their livelihood. Their compensation structure does not award them to spend more time than the fixed number of meetings they need to attend. Further, independent directors need to spend more time than inside directors to learn about the firm. Unless directors see clear evidence of wrongdoing or face an already exposed corporate crisis, they have a natural tendency to rely on the executives’ representation. Moreover, people serve on audit committees not because they will be likely to arduously search for potential wrongdoings. Rather, directors will wish to develop a collegial, not adversary, relationship with the executives. After all, a director’s job is much easier when he or she does not need to constantly challenge the executives. Therefore, even if independent directors on day one may not always say yes to the executives, over time, their initial alertness will gradually fade away. And “at the end of the day, most independent directors get neutralized in one fashion or another.”

Not only will SOX not achieve what Congress intended, a further problem with SOX is it encroaches into a regulatory regime that had long belonged to the states. The “genius of U.S. corporate law,” prior to SOX, had been that “corporations can choose their legal regime from the 50 states and the District of Columbia.” If one state’s law creates a substantial burden on a firm, the firm will simply incorporate in a different state. Moreover, as discussed in Section II.A, different firms require different board structures to best fit the particular firm’s business and special demand. Under a uniform federal statute, firms have no easy way to escape, even if the statute is extremely inefficient, unless these firms choose to delist.

186. Hermelin & Weisbach, supra note 48, at 111.
187. Romano, Corporate Law, supra note 21, at 313.
B. A Proposal to Delaware Courts: Expand the Good Faith Review

Absent changes at the state level, Congress, however, may not be willing to repeal SOX. After all, SOX is Congress's response to a spate of accounting scandals that shattered public confidence in the securities market. Although it is a poor means to an end, the threat of a negative political image may cause Congress hesitance to admit its fault in the short term. At the same time, the gap between corporate reality and state law's assumptions leaves most people unsatisfied with the current form of corporate governance. Perhaps judicial oversight alone is insufficient to transform corporate governance, but case law's insistence in a certain direction can and, in fact, often does lead to positive changes in people's behavior. Delaware is the pioneer and leader in corporate law. Delaware courts, for the most part, have restrained themselves from "intervening" into corporate business decisions. From time to time, when corporate scandals loom in the public mind, Delaware courts do react to strengthen their oversight of the board. For example, during the acquisition frenzy period in 1980s, Delaware courts issued a series of opinions, imposing various procedures and duties in the merger and acquisition area. In recent years, commentators have noticed that the Delaware courts have not been completely unresponsive to the spade of accounting scandals. The emphasis on "good faith" in the Disney opinions suggests that Delaware judges are eager to develop a suitable judicial doctrine to enhance their oversight over board conduct without unduly interfering with corporate business matters. This Section proposes that the Delaware court adopts an expansive good faith review for overall board operations instead of focusing solely on the particular board decision that leads to the litigation. The "good faith" doctrine is particularly suitable to take into account the three negative factors identified in this Article that affect board monitoring: board members' conflict of interest, the collective action problem, and executives' entrenchment incentive over board members.

Subsection III.B.1 lays out the expansive good faith evaluation proposed. This Subsection also briefly describes the business judgment rule and the main justifications for this rule. The following two Sub-

188. See Romano, Sarbanes-Oxley, supra note 13, at 1602.
189. Romano, Sarbanes-Oxley, supra note 13, at 1523, 1525.
190. See Romano, Corporate Law, supra note 21, at 317.
192. See id. at 44-46.
193. Id. at 52.
sections explain why the expansive good faith evaluation will not interfere with these justifications for the business judgment rule. The last Subsection applies the expansive good faith evaluation to the Disney example described in Subsection II.C.1 above.

1. The Good Faith Exception to the Business Judgment Rule

Under Delaware law, board directors traditionally face two types of fiduciary duties: the duty of loyalty and the duty of care. The duty of loyalty mainly deals with self-dealing transactions. It requires a corporate director or officer who enters a transaction with the corporation to "fully disclose all material facts to the corporation's disinterested representatives and to deal with the company on terms that are intrinsically fair in all respects." The duty of care requires a director to perform his or her functions (1) in good faith, (2) in a manner the director reasonably believes to be in the best interests of the corporation, and (3) with the care that a person in a like position would reasonably believe appropriate under similar circumstances. Although the duty of care standard reads similar to an ordinary negligence standard in tort law, courts have long introduced the business judgment rule to insulate directors' performance from judicial scrutiny in most situations. Under the business judgment rule, the law presumes 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."

Courts and scholars have identified two principal justifications for the business judgment rule: (1) a negligence standard deters risk taking by corporate officers and directors, a situation shareholders do not prefer; and (2) judges are not business experts. In addition to

194. Id. at 9; see also Cede & Co. v. Technicolor, Inc. 634 A.2d 345, 361 (Del. 1993).
196. ALLEN & KRAAKMAN, supra note 179, at 285.
197. REVISED MODEL BUS. CORP. ACT § 8.30 (2002).
199. Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984); In re Walt Disney Co. Derivative Litig. (Disney III), 906 A.2d 27, 52 (Del. 2006).
200. See Gagliardi v. Trifoods Int'l, Inc., 683 A.2d 1049, 1052 (Del. Ch. 1996). There, the court noted:

Shareholders can diversify the risks of their corporate investments. Thus, it is in their economic interest for the corporation to accept in rank order all positive net present value investment projects available to the corporation, starting with the highest risk adjusted rate of return first. Shareholders don't want (or shouldn't rationally want) directors to be risk averse.

Id. (emphasis in original).

these two justifications, Professor Bainbridge, a strong proponent of the business judgment rule, has identified an additional justification: judicial review of business decisions could "interfere with—or even destroy—the internal team governance structures that regulate board behavior."202

Significantly, to allow the business judgment rule to apply, a director must have acted in good faith.203 A plaintiff can rebut the business judgment presumption by showing that a director breached the duty of care or duty of loyalty, or the director acted in bad faith.204 If the plaintiff successfully rebuts this presumption, the burden shifts to the director-defendant "to demonstrate that the challenged act or transaction was entirely fair to the corporation and its shareholders."205 This good faith requirement is codified in several provisions of the Delaware General Corporation Law (DGCL). Under Section 102(b)(7) of the DGCL, Delaware corporations, in their charter provisions, can exculpate their directors from monetary liability for a breach of the duty of care, provided that the directors acted in good faith.206 Section 145 of the DGCL allows Delaware corporations to indemnify directors for the costs and outcomes of litigation, provided that the directors acted in good faith.207

Prior to the Disney litigations, this good faith requirement occurred in case law only occasionally. In Cinerama, Inc. v. Technicolor, Inc., the Delaware Supreme Court specifically referred to a director's "triad of fiduciary duties": "to rebut the [business judgment] presumption, a shareholder plaintiff assumes the burden of providing evidence that the board of directors, in reaching its challenged decision, breached any one of its triad of fiduciary duties: good faith, loyalty, or due care."208 Scholars have counted at least a dozen Delaware cases, decided prior to Disney, that adopted the "triad of fiduciary duties."209 However, Delaware courts had not extensively addressed the exact meaning of good faith until in Disney.

203. See supra note 199.
204. Disney III, 906 A.2d at 52 (Del. 2006).
205. Id.
In the *Disney* litigations, the issue of good faith played a prominent role.\textsuperscript{210} In the trial court, Chancellor Chandler referred to the good faith issue in the negative and asked whether the directors had acted in bad faith.\textsuperscript{211} Chancellor Chandler then went on to define bad faith:

Upon long and careful consideration, I am of the opinion that the concept of *intentional dereliction of duty, a conscious disregard for one's responsibilities*, is an appropriate (although not the only) standard for determining whether fiduciaries have acted in good faith. Deliberate indifference and inaction in the face of a duty to act is, in my mind, conduct that is clearly disloyal to the corporation. It is the epitome of faithless conduct.\textsuperscript{212}

On appeal, the Delaware Supreme Court provided three categories of fiduciary behavior as "candidates for the 'bad faith' pejorative label."\textsuperscript{213} The first category "involves so-called 'subjective bad faith,' that is, fiduciary conduct motivated by an actual intent to do harm."\textsuperscript{214} The court refers to this conduct as the "classic, quintessential bad faith."\textsuperscript{215} The second category is the most confusing because the conduct "involves lack of due care—that is, fiduciary action taken solely by reason of gross negligence and without any malevolent intent."\textsuperscript{216} The court took pains to explain that, in a psychological sense, "[t]he conduct that is the subject of due care may overlap with the conduct that comes within the rubric of good faith."\textsuperscript{217} But as a legal matter, according to the court, the two standards are not the same. Thus, "grossly negligent conduct, without more, does not and cannot constitute a breach of the fiduciary duty to act in good faith."\textsuperscript{218} Yet the court does not clarify what conduct in addition to gross negligence constitutes bad faith. The third category of conduct not in good faith, according to the Delaware Supreme Court, is the type defined by Chancellor Chandler, i.e., "intentional dereliction of duty, a conscious disregard for one's responsibilities."\textsuperscript{219} Different wordings aside, the third category appears to be a specific example of the second category. When directors consciously disregard their responsibilities, their conduct should also have been grossly negligent. Thus, this "conscious

\textsuperscript{210} *Disney III*, 906 A.2d at 63.
\textsuperscript{211} *In re* Walt Disney Co. Derivative Litig. (*Disney II*), 907 A.2d 693, 753 (Del. Ch. 2005).
\textsuperscript{212} *Disney II*, 907 A.2d at 755 (emphasis in original).
\textsuperscript{213} *Disney III*, 906 A.2d at 64.
\textsuperscript{214} *Id.*
\textsuperscript{215} *Id.*
\textsuperscript{216} *Id.*
\textsuperscript{217} *Id.* at 65.
\textsuperscript{218} *Disney III*, 906 A.2d at 65.
\textsuperscript{219} *Id.* at 66 (emphasis omitted).
disregarding” attitude appears to be the extra behavior on top of gross negligence that makes the conduct not in good faith.

Although the Delaware Supreme Court attempted to provide “some conceptual guidance to the corporate community” the above analysis, the court’s three categories are far from clear. Perhaps, as Professor Griffith argued, this focus on good faith in recent Delaware cases is simply rhetoric in Delaware corporate law jurisprudence in response to the scandals in recent years. According to Professor Griffith, the good faith analysis “operates as a speech act, a performance, as opposed to a careful method of analysis.” Once the crisis and scandals fade away in the public mind, Professor Griffith predicts that the court will return to the old position of board deference.

However, to recapture Delaware’s dominance in corporate law from the federal intrusion and to establish the law’s positive role in shaping corporate governance, Delaware judges should not treat this “good faith” analysis as temporal rhetoric in crisis time. Instead, the duty of good faith should be expanded to cover problematic board conduct that falls outside the traditional duties of care and loyalty. As discussed in Part II, boards have a tendency to stay passive because: (1) directors have a conflict of interest; that is, their loyalty is to the executives, not shareholders; (2) directors have their own collective action problem among themselves; and (3) executives have a natural tendency to entrench the board. Neither the traditional duty of care nor duty of loyalty analysis addresses these issues because the traditional analysis focuses on a specific board action or inaction that is the subject of litigation. Surely directors for publicly traded companies have a busy life and have to consider a variety of different agendas for the firm. The business judgment rule prevents judges from falling into the hindsight bias. Without the business judgment rule, a judge may, ex post, require directors to have considered one business decision more thoroughly than others just because this decision turned out to become the subject of litigation. Accordingly, judges impose a low threshold for directors to pass their fiduciary duty obligations: a board decision passes muster as long as directors made the decision on an informed basis and in good faith. A director only needs to “know the facts” to be able to make a decision on “an informed basis.”

220. Id. at 64.
221. See Griffith, supra note 191.
222. Id. at 1.
223. Id. at 2.
Instead of focusing on a specific transaction in dispute, I propose that the court expand its review of board operations by examining how the board generally performs its monitoring role. The court should allow plaintiffs to show, under the good faith prong, that the board has been operating in a way so passive that the board almost always casually disposes all the corporate matters or defers to the executives. Because if, in general, the board casually performs its monitoring role, it could not have properly deliberated the particular board decision in dispute. In this situation, the business judgment presumption does not apply, and the burden shifts to the defendant to prove that the particular board decision in the dispute was fair to the corporation and to the shareholders.  

This expansive review for board operations also fits in Chancellor Chandler's "intentional dereliction of duty, a conscious disregard for one's responsibilities" test. After all, if board directors generally disregard their responsibilities, they could not have thoroughly considered the particular board action in dispute. Under this expansive board review, the court should examine board operations both on an individual director's basis and on the whole board. On an individual director's basis, the court should ask, in general, whether each board director has performed his or her monitoring role and how he or she has approved major business decisions. For example, the court should examine the time and effort each director devotes into the firm's business; how much each director knows about the firm and the matters he or she had to decide; how each director approves a transaction; and whether a director always blindly follows the executives' recommendation or his or her colleagues' lead without providing independent input.

224. Note that this test is more expansive than the tests in Graham and Caremark. In Graham v. Allis-Chalmers Manufacturing Co., 188 A.2d 125 (Del. 1963), the corporation and four of its mid-level managers pled guilty to price-fixing charges, causing big fines imposed on the corporation. Id. Corporate shareholders brought a derivative suit against directors and top officers, alleging that the directors and officers failed to take actions designed to learn of and prevent such antitrust violations by corporate employees. Id. The court held that the directors were not liable because the plaintiffs had shown no evidence that had put the directors on notice that employees had engaged in conduct violating antitrust laws. Id. In In re Caremark International Inc. Derivative Litigation, 698 A.2d 959 (Del. Ch. 1996), lower-level officers engaged in misconduct violating the Anti-Referral Payments Law that cost $250 million fines to the corporation. Id. Although the court found that the directors have an obligation (an affirmative duty) to ensure the corporation's reporting system is adequate, the court did not find that the directors were liable because the corporation's information systems appear to have represented a good faith attempt to be informed of the relevant facts from its employees. Id. In both Graham and Caremark, the courts still focused on only the boards' inaction surrounding the particular misconduct that damaged the corporation. Graham, 188 A.2d 125; Caremark, 698 A.2d 959. The courts in those two cases did not look at the boards' operation in general, beyond the damaging misconduct.

225. See supra note 219.
To the board as a whole, the court should evaluate the overall atmosphere within the board and be sensitive to the executives' entrenchment tendency. Chancellor Chandler acknowledges in Disney that the good faith prong is particularly suitable when a corporation is governed by an "imperial CEO":

It is precisely in this context—an imperial CEO or controlling shareholder with a supine or passive board—that the concept of good faith may prove highly meaningful. The fiduciary duties of care and loyalty, as traditionally defined, may not be aggressive enough to protect shareholder interests when the board is well advised, is not legally beholden to the management or a controlling shareholder and when the board does not suffer from other disabling conflicts of interest, such as a patently self-dealing transaction. Good faith may serve to fill this gap and ensure that the persons entrusted by shareholders to govern Delaware corporations do so with an honesty of purpose and with an understanding of whose interests they are there to protect.226

Without evaluating the general atmosphere at the board and looking beyond the particular transaction in dispute, the court may not have sufficient evidence to be able to label a dominant executive as the "imperial CEO." When evaluating overall board operations, the court should focus on how the executives in general approach board members. For example, does the board have an executive so dominant that the directors regularly have been unable or unwilling to challenge the executive? Does the executive normally approach and inform the board on an individual basis or on a collective basis? Does the executive constantly play politics around board members, attempting to tailor to individual directors' personal interest in order to achieve what the executive desires? Is the board's atmosphere professional and conducive to productive decision making? Taking these factors into consideration will help curtail executives' entrenchment tendency. Although judges do not wish to mandate how the board conducts its business, evaluating the board's general atmosphere does not intrude into directors' decision making but may push boards into building a more active and productive environment.

2. An Expansive Good Faith Evaluation Is Not Counterproductive

Allowing the plaintiffs to show board passivity beyond the transaction in dispute should not deter directors' risk taking or discourage qualified individuals from serving on the board. One of the main justifications for the business judgment rule is that judicial challenge to

directors' decisions ex post deters directors' risk taking. Corporate officers and directors invest other people's money. Shareholders can eliminate firm-specific risk by diversifying their portfolio so they prefer optimal risk taking by corporate officers and directors. In the absence of the business judgment rule, corporate officers and directors would bear the full costs of the downside of a risky project, but they would receive only a small fraction of the gains from the upside of the risky project. Accordingly, judges have invoked the business judgment rule to prevent themselves from falling into the inevitable hindsight bias when second-guessing a corporate decision. A more expansive good faith evaluation, however, should not deter directors' risk taking any more than the current transactional approach. Under the expansive approach, judges do not scrutinize more thoroughly than under the current approach for the particular board decision in dispute. Instead, judges simply expand the horizon, looking beyond the transaction and evaluating the board operation in general. The weakness under the transactional approach is that it isolates one transaction from the board's overall operation. When the board considers a business matter ex ante, it may not know exactly how the decision will affect the business, or the board may have reasonably overlooked the importance of its decision; that is, the decision may turn out to be more important than the board initially considered. Thus, unless the plaintiffs bring strong evidence of directors' self-dealing or gross negligence in this one transaction, the plaintiffs are unlikely to succeed in their claims. Facts surrounding one transaction often are too limited to prove that the directors have consciously disregarded their duties. Under the expansive good faith evaluation, however, if the pattern of the board operation shows that the directors almost always casually dispose their duties and always blindly follow the executives' recommendations, then the plaintiffs may succeed in their claims.

Corporate boards consider a variety of business matters. Without showing how the board operates over a number of matters, plaintiffs can hardly show that the board has consciously disregarded its duties. At the same time, judges still do not impose their own business ideas when evaluating the board's overall operation. Judges will simply evaluate whether the pattern of board operation demonstrates that it

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227. AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 4.01 cmt. d at 141 (1994); Bainbridge, supra note 202, at 29.
228. See Gagliardi v. Trifoods Int'l, Inc., 683 A.2d 1049, 1052 (Del. Ch. 1996); Bainbridge, supra note 202, at 31.
229. ALLEN & KRAAKMAN, supra note 179, at 241.
was passive or active. Thus, this expansive good faith evaluation should not deter directors' risk taking.

Moreover, the expansive good faith approach should not deter qualified individuals from serving on the board. On the contrary, qualified individuals may have more incentive to serve as directors under the expansive approach than under the transactional approach. Judges are more likely to respect a director's decision when the director consistently and diligently serves his or her monitoring role, even if one unfortunate decision resulted in significant losses. Furthermore, because judges under the expansive approach are particularly sensitive to the general atmosphere at the board and the entrenchment tendency of the executives, corporate boards may have more pressure to develop into an active and productive environment. Qualified individuals should be more encouraged to serve on a board that treasures each board member's input rather than one that blindly defers to the executives. Under the expansive approach, corporate boards may actually have the incentive to evaluate their own monitoring behaviors on a regular basis.

On the other hand, a qualified individual may and should hesitate to serve on a board similar to the WorldCom board described above. The WorldCom board played virtually no role in the company's success or failure. It had an autocratic CEO, and directors almost never challenged him. Certainly that board did not treasure any of its director's expertise, and, if the court adopts the expansive good faith review, individuals serving on that type of board should have felt uncomfortable about failing their fiduciary duties.

Professor Bainbridge has argued for an additional justification for the business judgment rule: judicial review of business decisions could interfere with the board's internal dynamics. He argues that the board of directors is a relational team and that members of this team "develop idiosyncratic working relationships with one another." The team also develops its specific human capital and idiosyncratic internal review and monitoring processes for its members. Judicial review of board decisions, according to Professor Bainbridge, may "destroy the interpersonal relationships that foster these forms of internal board governance." He further argues that the board's inter-

230. See supra Part II.C.2.
231. See supra text accompanying note 141.
232. Bainbridge, supra note 202, at 44.
233. Id.
234. Id. at 45-46.
235. Id. at 46.
nal dynamics theory explains the "inapplicability of the business judgment rule to fraud or self-dealing."\(^{236}\)

When an individual director decides to pursue a course of self-dealing, however, he or she usually acts alone and, moreover, betrays his or her fellow directors' trust. It makes sense for courts to be less concerned with damage to internal team governance when the defendant director's misconduct has already harmed that governance structure through betrayal.\(^{237}\)

The expansive good faith evaluation I propose is consistent with the board's internal dynamics theory Professor Bainbridge argues. A well-functioned board with productive internal board governance is more likely to receive a judge's deference than a poorly operated board. The expansive good faith review should foster boards to develop and maintain its internal governance structure. Judges are more likely to appreciate a board's well-established internal dynamics under an expansive good faith review rather than under the transactional approach. This is because, under the transactional approach, judges may have too limited facts to recognize the board's internal dynamics.

3. Judges Are Well Suited to Evaluate Directors' Good Faith

The second main justification for the business judgment rule is that judges are not business experts.\(^{238}\) Perhaps many judges lack general business expertise and are ill-equipped when having to dig through complex financial analysis, but Delaware chancellors often have significant prior corporate experience.\(^ {239}\) Moreover, as Professor Bainbridge points out, medical doctors and engineers do not receive similar deference as business people, and most judges do not have more medical or engineering experience than business experience.\(^ {240}\)

Thus, this business expertise rationale in reality is the same as the risk-averse rationale discussed above. Reasonable minds may differ given the same set of facts, so judges should not second-guess a well deliberated business decision, even if the decision turned out to be wrong. The expansive good faith evaluation I propose does not call upon judges to impose their own business opinions for the board decision in dispute. Instead, the good faith evaluation is more similar to a moral judgment valuation that judges frequently perform. Judges do not decide whether the particular business decision is correct or not. Instead, they focus on the entire board operation and general board atmos-

\(^{236}\) Id.
\(^{237}\) Bainbridge, supra note 202, at 46-47 (citations omitted).
\(^{238}\) See supra note 201.
\(^{239}\) Bainbridge, supra note 202, at 40.
\(^{240}\) Id. at 39-40.
sphere to see whether, given how the board in general performs its duties, the board has been so passive or an executive has been so dominant that virtually all of the board decisions are inadequately made.

One potential concern to the expansive good faith evaluation is that judges will be presented with far more evidence than under the current transactional approach. But if this approach will help corporate boards to become more active and their working relationship with the executives more productive, the additional cost is well worth it. Both Chancellors Strine and Chandler have argued that the highly specific federal rules in SOX are an intrusion to the more flexible and "principles-based" state law. They also admit that this federal encroachment into state law "may be due in part to the failure of Delaware law to respond with sufficient speed to changes in business practices." Then, accordingly, Delaware law should step up to deal with the board passivity problem rather than simply adding rhetoric only in times of crisis and scandals. Time will prove the SOX ineffective, which means a significant void still exists in our corporate law. Moreover, crisis and scandals accumulate during peaceful time. If the expansive good faith review pressures boards to properly govern their own monitoring role, this benefit is well worth the additional evidentiary cost to the courts.

4. Application: Disney

In this Subsection, I apply the expansive good faith evaluation I proposed to the Disney case described in Section II.C above. When performing the expansive good faith evaluation, besides focusing on the Disney board's deliberation surrounding the hiring of Michael Ovitz, as Chancellor Chandler did in the Disney litigations, the court should also allow plaintiffs to show that the Disney board consistently disposed of its decisions quickly and casually by almost always following Eisner's direction. The court noted how swiftly the board approved the employment agreement with Ovitz: (1) Eisner and his personal attorney were primarily responsible for negotiating the terms of the employment agreement; (2) they informed the hiring decision and the terms to two members of the compensation committee by phone; (3) the compensation committee approved the deal in its one-hour meeting, during which the committee also considered other

242. Griffith, supra note 191, at 50.
agendas; and (4) the board then voted to approve the deal during its board meeting, which was led by Eisner.\textsuperscript{243} Certainly for a multi-billion dollar company like Disney, the board may not need to spend a considerable amount of time deliberating a compensation package worth hundreds of millions of dollars. The Disney board probably had to discuss a number of important business agendas on a regular basis, so, for Ovitz's hiring, the Disney board did not feel that it had to spend more time than what it actually spent. But suppose the Disney board disposed virtually all of its important business decisions in the same fashion as how it approved Ovitz's employment agreement. Then the board is more likely to have consciously disregarded its responsibilities. If a board simply disposes its duties by following the executives' directions, then the board is more like a façade, without performing any useful functions, let alone performing any monitoring role.

To be sure, Chancellor Chandler was sensitive to Eisner's dominance in the board. When discussing the good faith doctrine, Chancellor Chandler mentions the "imperial CEO," implying Eisner's control over the board.\textsuperscript{244} But if the court only focuses on facts surrounding Ovitz's hiring decision, then no matter how dominant Eisner was in this one transaction, the court may not be certain that this dominance rises to the level of an imperial CEO. The court, as particularly sensitive to its hindsight bias, may be unable to conclude that the board was virtually useless based on only the facts surrounding this one transaction. If the court saw a consistent pattern of Eisner guiding the board in virtually all matters, then the plaintiffs would have a much stronger claim that the board was not in good faith and failed its fiduciary duty.

IV. Conclusion

Boards of directors in the real world possess a number of characteristics contrary to what the law assumes. The law's wrong assumptions explain why boards of directors have performed their monitoring job unsatisfactorily to most shareholders and to the public despite existing case law protections for shareholders. First, shareholders do not choose most directors. Instead, shareholders elect the directors because firms' executives have nominated the directors on the election ballot. As a result, directors naturally are more loyal to the executives

\textsuperscript{243} See Part II.C.2.

\textsuperscript{244} In re Walt Disney Co. Derivative Litig. (Disney II), 907 A.2d 693, 761 n.487 (Del. Ch. 2005).
than to the shareholders. Second, within the board, directors face the same collective action problems as faced by shareholders. The directors are of equal status on the board, so each member shares a small portion of the benefit from monitoring but has to bear the full cost. The directors have a poor incentive to be active because their compensation usually does not award them to spend extra effort than to merely attend board meetings. The boards' large size for most publicly traded companies further aggravates the collective action problem. Third, executives have a natural tendency to entrench the board. This tendency drives the board members to gradually defer to the executives.

Independent directors still face the same problems as insider directors, and, in many situations, problems are even worse with independent directors. The independent directors are still chosen by a firm's executives, their livelihood is less attached to the firm's success, and they must spend more effort than insider directors to learn about the firm. Except perhaps during crisis, independent directors are not better than insider directors in their monitoring role. This explains why studies have consistently concluded that independent directors do not improve a firm's performance and these directors have a positive influence on the firm at best during crisis. Disney, WorldCom, and Enron are three recent examples of massive boards' monitoring failure, even though, in all three cases, the boards were composed of a majority of independent directors.

Despite studies' consistent findings that independent directors do not perform a better monitoring role, Congress enacted the Sarbanes-Oxley Act, under which all publicly traded corporations must have audit committees composed entirely of independent directors. But even though SOX is a poor means to an end, it is Congress's response to public outcries over a series of corporate scandals. This response also reflects how state law has unsatisfactorily shaped corporate governance. Therefore, states, particularly Delaware, should step up and reassess its basic legal assumptions towards boards' role. I propose that the Delaware courts adopt an expansive good faith evaluation for overall board operations instead of focusing solely on the transaction in dispute. Without looking beyond one board transaction, the court may not have sufficient facts to conclude that the board has, in general, failed its monitoring role. This expansive good faith evaluation should not deter directors' risk taking or deter qualified individuals

245. See supra text accompanying note 183.
246. See supra text accompanying note 189.
from serving on corporate boards. Moreover, this expansive good faith evaluation is more like a character valuation, for which judges are well suited and often called upon to perform. This expansive good faith evaluation may add pressures to corporate boards to evaluate their own monitoring role on a regular basis and may thus push them to become more active.

A magic formula to cure boards' monitoring deficiencies probably does not exist. But a uniform federal statute making rigid requirements on all publicly traded corporations creates only inefficiencies without leading to any of the intended consequences. These inefficiencies will eventually be borne by shareholders and the overall economy. Time is set for state law to make a drastic change.