2006

The Chaos of Smith.

Steven A. Ramirez
Loyola University Chicago, sramir3@luc.edu

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I. Introduction

The *Smith v. Van Gorkom*[1] decision received mixed reviews, at best, when it debuted twenty years ago.[2] One commentator thought the decision "atrocious."[3] Another called it "one of the worst decisions in the history of corporate law."[4] This article takes a different approach.[5] I argue the decision was sound.[6] If there is anything atrocious about *Smith*, it is its legacy.[7] Special interest influence took grip of corporate governance in America in the wake of *Smith* and drastically altered shareholder rights in a most pernicious fashion by eviscerating the duty of care through insulating legislation.[8] This diminution in shareholder rights is not costless, and the economic drag associated with sub-optimal corporate governance continues to impose real costs today.[9] Indeed, *Smith* ushered in an age of CEO pri-

* Professor of Law, Washburn University School of Law. I dedicate this article to my Business Associations students at Washburn University School of Law from 1996 through 2005.

1. 488 A.2d 858 (Del. 1985).

2. Barry F. Schwartz & James G. Wiles, Trans Union*: Neither "New" Law nor "Bad" Law*, 10 Del. J. Corp. L. 429, 429 n.2 (1985).

3. *See* Bayless Manning, *Reflections and Practical Tips on Life in the Boardroom After* Van Gorkom, 41 Bus. Law. 1, 1 (1985).

4. Daniel R. Fischel, *The Business Judgment Rule and the* Trans Union *Case*, 40 Bus. Law. 1437, 1455 (1985).

5. Even those arguing for a kinder assessment of *Smith* are harsh regarding its central finding that the duty of care was breached under the facts of the case. *See* Lawrence A. Hamermesh, *A Kinder, Gentler Critique of* Van Gorkom *and Its Less Celebrated Legacies*, 96 Nw. U. L. Rev. 595, 596 (2002) (arguing that although *Van Gorkom* was wrong, it correctly resolved certain ancillary issues).

6. Professors Elson and Thompson have recognized that *Smith* was a "wake up call to passive boards that had been the norm in the decades prior to the decision." Charles M. Elson & Robert B. Thompson, Van Gorkom*'s Legacy: The Limits of Judicially Enforced Constraints and the Promise of Proprietary Incentives*, 96 Nw. U. L. Rev. 579, 583 (2002). Still, they conclude that the decision was "ultimately misdirected." *Id.* at 593; *see also* Stephen M. Bainbridge, *Why a Board? Group Decisionmaking in Corporate Governance*, 55 Vand. L. Rev. 1, 54 (2002) ("[T]he oft-repeated law and economics critique of *Van Gorkom* appears overblown. . . . [T]here is a rational basis for the seemingly formalistic procedures mandated by that opinion.").

7. *See* Franklin A. Gevurtz, Corporation Law § 4.1.7 (2003) (stating that, in response to *Smith*, state legislatures enacted insulating statutes permitting the obliteration of the duty of care within the corporation charter, with Delaware leading the way).

8. *See* Marc I. Steinberg, *The Evisceration of the Duty of Care*, 42 Sw. L.J. 919, 929 (1988). In general, superior investor protection enhances a firm's ability to raise external financing and thereby supports greater economic growth. *See, e.g.*, Rui Castro, Gian Luca Clementi & Glenn MacDonald, *Investor Protection, Optimal Incentives, and Economic Growth*, 119 Q.J. Econ. 1131, 1131-35, 1166-67 (2004).

9. Steven A. Ramirez, *Rethinking the Corporation (and Race) in America: Can Law (and Professionalization) Fix Minor Problems of Externalization, Internalization and Governance*, 79 St. John's L. Rev. (forthcoming 2005) (positing that a macroeconomically optimal corporation would not externalize costs, would exploit profitable mass investment opportunities, and would minimize agency costs); *see also* Marco Becht, Patrick Bolton & Ailsa Röell, *Corporate Governance and Control*, *in* 1A Handbook of the Economics of Finance 1 (George M. Constantinides, Milton Harris & René M. Stulz eds., 2003) (stating that corporate governance must stem self-dealing by managers and that soaring executive compensation in the United States is difficult to justify).

macy in American corporate governance, ensconced in law and buttressed by raw political power.[10]

This article posits that the most remarkable element of the decision in *Smith* is the court's disposition of a motion for reargument filed by one individual defendant-director.[11] This oft-ignored gem[12] explains the entire decision; indeed, it demonstrates the "Chaos"[13] governing the law, particularly in the context of complex legal and regulatory systems such as corporate governance that are permeated by special interest influence.[14] The paradox of *Smith* is that, while it was perceived to heighten the duty of care applicable to directors of corporations, it in fact operated to dilute the obligations of the directors.[15] I argue that the decision in *Smith* placed corporate governance on the path to a CEO-centric model, rather than a shareholder pri-

10. JOHN C. BOGLE, THE BATTLE FOR THE SOUL OF CAPITALISM 28 (2005) ("The change from traditional owners' capitalism to the new managers' capitalism is at the heart of what went wrong in corporate America" during the early 2000s.). The duty of care is not the only element of the law that has shifted power to CEOs as a result of political power. For example, the Private Securities Litigation Reform Act of 1995 diminished the exposure of corporate managers to private claims under the federal securities laws as a direct consequence of special interest influence from the accounting industry and the business community. *See* Steven A. Ramirez, *Arbitration and Reform in Private Securities Litigation: Dealing with the Meritorious as well as the Frivolous*, 40 WM. & MARY L. REV. 1055 (1999). Recently, management interests have trumped the SEC's efforts to break the stranglehold that management has over the proxy machinery and therefore voting power within the public corporation. Andrew Parker, *It Is Time for a Transfer of Power*, FIN. TIMES (London), Aug. 4, 2005, at 10 (stating that ferocious opposition from corporate CEOs had stifled proxy reform, leading to management power over the director selection process and higher compensation).

11. Smith v. Van Gorkom, 488 A.2d 858, 898-99 (Del. 1985).

12. Few commentators have written more incisively about *Smith* than Professor Hamermesh. Yet he does not mention the motion for reargument. *See generally* Hamermesh, *supra* note 5; Lawrence A. Hamermesh, *Why I Do Not Teach* Van Gorkom, 34 GA. L. REV. 477 (2000) [hereinafter *Why I Do Not Teach* Van Gorkom]. The harshest critics of *Smith* similarly fail to recognize the joint defense pursued by Van Gorkom and the outside directors. *See generally* Manning, *supra* note 3.

13. The word "Chaos" as used in this paper is a term of art, referring to a science that has emerged relating to certain mathematical models. PETER SMITH, EXPLAINING CHAOS 1 (1998). There is no well-established corollary in law to Chaos Theory as it has developed within the natural sciences. Nevertheless, one may draw clear analogies between the science of Chaos Theory and law. Chaos Theory may provide insights into legal dynamics that can assist in drawing positive and normative conclusions regarding certain legal systems that seem to fit well within the science of Chaos Theory. This article submits that the duty of care applicable to public corporations in the United States is such a doctrine. *See* Euel Elliott & L. Douglas Kiel, *Introduction*, *in* CHAOS THEORY IN THE SOCIAL SCIENCES 1-15 (L. Douglas Kiel & Euel Elliott eds., 1997) (stating that Chaos Theory has been increasingly applied to social sciences such as economics, political science, and sociology). I intend to demonstrate that corporate governance is subject to Chaos since its outcomes exhibit sensitive dependence on initial conditions, and slight differences in conditions may lead to widely divergent outcomes in the content of corporate governance. *See id.* at 6.

14. *See* Steven A. Ramirez, *Depoliticizing Financial Regulation*, 41 WM. & MARY L. REV. 503 (2000) (arguing that special interest influence permeates financial regulation, generally, and corporate governance, in particular, due to public inattention which inevitably leads to political overreaction when a crisis occurs).

15. James J. Hanks, Jr., *Evaluating Recent State Legislation on Director and Officer Liability Limitation and Indemnification*, 43 BUS. LAW. 1207 (1988) (stating that, between April 1986 and the middle of 1988, forty states responded to the application of gross negligence articulated by *Smith* with insulating legislation aimed at reducing the risk of director liability for duty-of-care violations).

macy model.[16] This was certainly not the intent of the Delaware Supreme Court, nor the various state legislatures that responded to *Smith* by eviscerating the duty of care applicable to corporations in the United States.[17] That is the nature of Chaotic systems under Chaos Theory: Small changes in initial conditions may give rise to radically different and unpredictable outcomes.[18] This article seeks to demonstrate that the stylized facts of *Smith* radically changed corporate governance in America in unpredictable ways.[19]

Part II of this article provides a new narrative for *Smith.* Under this new narrative, the outside directors are cast not as victims of an ill-founded effort by the Delaware Supreme Court to re-write the law of director liability, but are instead victims of a sub-optimal defense strategy and a truly errant CEO. Part III of this article traces the devolution of corporate governance standards that followed in the wake of *Smith*, in terms of its economic impact. This devolution has been marked by a march of ever more promiscuous standards of conduct for managers of public corporations, a march that has coincided with the onset of CEO primacy in corporate America. This article concludes that this outcome was so unpredictable that perhaps Chaos Theory, so prominent in modern science, may serve to deepen the understanding of how the legal system actually functions and provide a lens that carries normative import. The article concludes that the legal system tends to demonstrate Chaos, at least within complex systems permeated by special interest influence governing areas such as corporate governance.

16. Perhaps the most concise method of demonstrating the ascendancy of the CEO-centric model of corporate governance that has taken hold since *Smith* would be to follow the money. If compensation is the litmus test of CEO power, then the years since *Smith* suggest that CEO power is on the upswing. Lucian Bebchuk & Yaniv Grinstein, *The Growth of U.S. Executive Pay*, 21 OXFORD REV. ECON. POL'Y 283 (2005) (finding that the proportion of S&P 500 profits going to top executive compensation approximately doubled as a percentage of profits from 1993 to 2003).

17. The putative policy basis of insulating directors from liability for breaches of the duty of care was a supposed directors and officers insurance crisis. Michael Bradley & Cindy A. Schipani, *The Relevance of the Duty of Care Standard in Corporate Governance*, 75 IOWA L. REV. 1, 43 (1989). This seems odd given that profitability, as reflected in market value, for this line of insurance carriers soared following the *Smith* decision. *Id.* at 48.

18. In Chaos Theory terminology, this is known as the butterfly effect. The butterfly effect stems from the notion that a butterfly's wings in Beijing can influence weather systems on the east coast of the United States in powerful ways. JAMES GLEICK, CHAOS: MAKING A NEW SCIENCE 8 (1987). This is why weather systems are impossible to predict.

19. For example, prior to *Smith*, directors were not frequently found answerable for "mere negligence," but liability did attach in bank cases, for gross negligence, and for directors who could be termed mere figureheads. Joseph W. Bishop, Jr., *Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers*, 77 YALE L.J. 1078, 1095-96 (1968) (citing numerous authorities). Indeed, Professor Bishop cited four cases in which directors were held answerable for negligence. *Id.* at 1099-101. This relatively infrequent liability for "mere negligence" was transmogrified in the wake of *Smith* into a rule of no liability in the absence of intentional misconduct. *See supra* note 8.

Chaos Theory is a mathematical concept that has its roots in the study of weather systems.[20] Edward Lorenz developed a meteorological model using simple differential equations to explain atmospheric convection.[21] Lorenz found that minute variances in initial conditions resulted in dramatic changes in the weather predictions yielded by his model.[22] This "sensitive dependence on initial conditions" is a mark of Chaos.[23] This element of Chaos is also known as the "butterfly effect"—describing the possibility that a butterfly opening its wings in China could impact the weather in faraway places.[24] Another element of Chaos is "large-scale order with small-scale disorder, of macro-predictability with . . . micro-unpredictability due to sensitive dependence."[25] This element of Chaos has also been summarized as "order out of chaos."[26] Specifically, while Chaos Theory suggests that unstable aperiodic behavior in deterministic nonlinear dynamical systems defies detailed predictions of outcomes, certain patterns may emerge from Chaos in a clear, even predictable way.[27] Nevertheless, Chaotic systems, although deterministic, defy control as a result of their micro-unpredictability; *Smith* demonstrates the central point of this article.[28] Chaos means law untethered to policy and a lack of real control by any single lawmaking or regulatory authority—whether Congress, management interests, the Delaware Supreme Court, or the various state legislatures that responded to *Smith*.

II. RETHINKING *SMITH*

The most pungent element of the *Smith* case is the gross negligence of Jerome Van Gorkom. Van Gorkom was the CEO of Trans

20. SMITH, *supra* note 13.
21. *Id.* at 9-16.
22. *Id.* at 10 ("Lorenz . . . discovered (by accident!) that if he numerically integrated the equations from minutely different . . . values then the values in the model after a relatively short time would be very different—the model, that is to say, exhibits a sensitive dependence on initial conditions."); *see also* Edward N. Lorenz, *Deterministic Nonperiodic Flow*, 20 J. ATMOSPHERIC SCI. 130, 141 (1963) (concluding that because "of the inevitable inaccuracy and incompleteness of weather observations, precise very-long-range forecasting would seem to be non-existant").
23. SMITH, *supra* note 13 (emphasis omitted).
24. *Id.*
25. *Id.* at 13 (emphasis omitted).
26. CHRISTOPHER R. WILLIAMS & BRUCE A. ARRIGO, LAW, PSYCHOLOGY, AND JUSTICE: CHAOS THEORY AND THE NEW (DIS)ORDER 15-34, 64-65 (2001).
27. STEPHEN H. KELLERT, IN THE WAKE OF CHAOS: UNPREDICTABLE ORDER IN DYNAMICAL SYSTEMS 2 (1993). A dynamical system is simply one that changes over time. Aperiodic instability means the system does not repeat itself. Nonlinear refers to sensitivity to initial conditions. Deterministic means that the system is not random. *Id.* at 3-4, 6. Some commentators add the concept of feedback to the definition, meaning that the output of the system influences the next outcome. JOE PRITCHARD, THE CHAOS COOKBOOK: A PRACTICAL PROGRAMMING GUIDE 32 (2d ed. 1996).
28. *See* Alvin M. Saperstein, *The Prediction of Unpredictability: Applications of the New Paradigm of Chaos in Dynamical Systems to the Old Problem of the Stability of a System of Hostile Nations*, *in* CHAOS THEORY IN THE SOCIAL SCIENCES 139 (L. Douglas Kiel & Euel Elliott eds., 1997).

Union Corporation, a publicly traded company, and had served in that capacity for seventeen years.[29] He was an officer of the company for twenty-four years and was both a certified public accountant and an attorney.[30] As such, he had much experience in corporate acquisitions.[31] Van Gorkom was also intimately familiar with a fundamental challenge facing Trans Union: It had more investment tax credits than it could use because it was generating insufficient taxable income.[32] Given this background, and his specialized knowledge, his behavior in pursuing the sale of Trans Union is difficult to fathom.[33]

For example, Van Gorkom solicited the purchase of Trans Union without any formal authorization from his board of directors to negotiate the sale of the company, and without consulting with any other senior officer of Trans Union, save one.[34] Van Gorkom met with the ultimate acquirer alone and opened negotiations without any legal advice or other professional consultation.[35] Indeed, Van Gorkom opened negotiations by proposing the sale of the company for $55 per share.[36] His basis for this price was weak at best.[37] While the price

29. Smith v. Van Gorkom, 488 A.2d 858, 864-66 (Del. 1985). Most commentators neglect to focus on Van Gorkom's individual expertise, background, and knowledge, just as they neglect to focus upon his individual culpability. *See, e.g.*, Stephen M. Bainbridge, Corporation Law and Economics 274-304 (2002); Gevurtz, *supra* note 7, at 274-320. My focus upon Van Gorkom's conduct is central to my thesis.

30. *Smith*, 488 A.2d at 865-66.

31. *Id.* at 866. "[I]n the late 1960s, and continuing through the 1970s, Trans Union pursued a program of acquiring small companies." *Id.* at 865.

32. *Id.* at 864. Van Gorkom lobbied Congress to make the "ITCs refundable in cash." *Id.* at 864-65.

33. Of course, Van Gorkom's specialized knowledge does not change the standard of care, only its application. *See* Restatement (Second) of Agency § 379 (1958). As a senior officer, Van Gorkom may be entitled to the protection of the business judgment rule to the extent he is exercising business judgment. *See, e.g.*, Principles of Corporate Governance § 4.01 (1992). Nevertheless, the common law agency duties owed by Van Gorkom are not comprehensively displaced by the business judgment rule.

34. *Smith*, 488 A.2d at 866. A CEO only has apparent authority, at best, to undertake those transactions that are in the ordinary course of business. Melvin Aron Eisenberg, Corporations and Other Business Organizations 211-15 (9th ed. 2005) (demonstrating limited apparent authority for corporate officers in general and CEOs in particular). Van Gorkom also seems to have had little actual authority in the sense that management submitted a five-year plan to the board that did not include the option of selling the company. *Smith*, 488 A.2d at 865.

35. *Smith*, 488 A.2d at 866. Professor Bainbridge suggests that Van Gorkom's go-it-alone strategy was "likely . . . quite damning" because it defied the economic basis for management teams and for the existence of a multi-person board of directors. "The take-away lesson is that deal-makers should, early in the process, consult with senior management and get them 'on board.'" Bainbridge, *supra* note 29, at 277.

36. *Smith*, 488 A.2d at 866. Van Gorkom picked this price "out of the air"; in fact, he relied upon a valuation study undertaken by the Trans Union CFO without speaking to that officer about the differences between that study and the proposed transaction with the acquirer. Bainbridge, *supra* note 29, at 278. When the CFO finally did learn of the deal, he thought the price was too low. *Id.* at 277.

37. *See Smith*, 488 A.2d at 865. "The well-advised board . . . obtains a fairness opinion that, at least in theory, gives them some basis for evaluating what the prospective buyer could afford, and would be willing, to pay." Bainbridge, *supra* note 29, at 279. This conception of a fairness opinion differs from seeking an opinion to justify a given price, and instead focuses on getting an opinion as an aid to negotiating a price. Additionally, Professor Bainbridge is not viewing the fairness opinion as a tool to find any "intrinsic value." He expressly recognizes the problematic nature of that term. *Id.* at 278.

represented a substantial premium over the market price, it was primarily based upon "rough form" analysis of the amount of debt the corporation could sustain in the context of a leveraged buy-out.[38] The leveraged buy-out would not have impounded the value of the tax credits held, but not fully utilized, by Trans Union due to its insufficient offsetting income.[39] The Delaware Supreme Court found Van Gorkom's suggested price basis inadequate because the transaction gave the acquirer complete control of the company.[40]

But, this inadequate price basis was only the beginning of Van Gorkom's gross negligence. Van Gorkom signed the merger agreement with the acquirer, Jay Pritzker, sight unseen at a social function, without the benefit of any legal or financial review by Trans Union's senior officers or legal department.[41] Van Gorkom instead retained outside counsel James Brennan to represent Trans Union in this transaction.[42] Brennan apparently gave the document only a cursory review, even though the agreement was drafted by representatives of the acquirer.[43] To sign such an agreement without even reading it seems almost unfathomable for any CEO, much less one with Van Gorkom's background.[44] Moreover, the agreement undercut a central feature of the transaction in terms of intent of the board to solicit competing bids, resulting in the board's inability to defend the reasonableness of its approval of the transaction.[45] Specifically, the agreement restricted both the ability of the board to solicit competing bids

38. *Smith*, 488 A.2d at 865. Not only was the analysis for the wrong type of transaction, it was a "very brief bit of work" that could only be termed a "preliminary study." *Id.* Trans Union's CFO, who supervised the study, called it a "very first and rough cut" that "did not purport to establish a fair price for . . . the [c]ompany." *Id.*

39. *See id.* at 865-66. A leveraged buy-out is the use of debt to purchase a company, usually using the firm's assets to secure the debt; consequently, a leveraged buy-out results in less income because the firm's cash flow must service the debt. *See* JACK P. FRIEDMAN, DICTIONARY OF BUSINESS TERMS 337 (1994).

40. *Smith*, 488 A.2d at 876-78. "[T]he record compels the conclusion that . . . the board lacked valuation information adequate to reach an informed business judgment as to the fairness of $55 per share for sale of the [c]ompany." *Id.* at 878. "In fact, however, we do not know whether the $55 per share was a good price for Trans Union's stock; the court in [*Smith*] remands for a determination of this issue." GEVURTZ, *supra* note 7, at 286. In other words, there may have been a breach of the duty of care without any damages. *Id.* at 286 n.42.

41. *Smith*, 488 A.2d at 867, 869. The company's CFO did not know about the proposed merger until the morning it was presented to the board. *Id.* at 869. "Van Gorkom did not consult with William Browder, a Vice-President and director of Trans Union and former head of its legal department, or with William Moore, then the head of Trans Union's legal staff." *Id.* at 867.

42. *Id.*

43. *Id.* "Pritzker's lawyer was then instructed to draft the merger documents, to be reviewed by Van Gorkom's lawyer, 'sometimes with discussion and sometimes not, in the haste to get it finished.'" *Id.* It is unclear who this attorney was, but it appears to have been James Brennan who Van Gorkom retained the next day to advise Trans Union on the legal aspects of the merger. *Id.*

44. *Id.* at 865-66, 869. "The [m]erger [a]greement was executed by Van Gorkom during the evening of . . . a formal social event that he hosted for the opening of the Chicago Lyric Opera. Neither he nor any other director read the agreement prior to its signing and delivery to Pritzker." *Id.* at 869.

45. *See id.* at 878.

and the availability of confidential financial information to other potential suitors.[46] Van Gorkom claimed that his failure to read the agreement was mooted by the directors' inherent right to approve or disapprove a merger.[47] The court, in a finding more consonant with contract law, held that the agreement indeed had legal effect and bound the company.[48]

Ultimately, the board voted to amend the agreement to preserve the so-called market test.[49] In particular, the board wanted to affirm and clarify the "right to openly solicit offers."[50] Van Gorkom signed the amendment, however, without assuring that it was in accord with the intent of the board.[51] The court opined that the amendments actually restricted the ability of the board to pursue competing bids.[52] One director testified that if the market-test provisions were absent from the documentation of the transaction, "then the management did not carry out the conclusion of the [b]oard."[53] The court specifically noted that Van Gorkom failed to assure that the documents he signed incorporated the conditions imposed by the board.[54] In all, the court paints neither Van Gorkom nor attorney Brennan in a favorable light. One is left to speculate whether the corporation had viable claims against these two agents, which would have focused liability on those most responsible for the losses.[55]

46. *Id.* Only attorney Brennan had access to the agreement at the meeting where the board approved the merger. *Id.* at 868 n.7. Van Gorkom told the board that "[t]he 'real decision' is whether to 'let the stockholders decide it.'" *Id.* at 868 n.8. Yet, Brennan apparently never advised the board that the agreement did not permit an unfettered auction of the company. Thus, the court's finding that the agreement as executed furnished "no rational basis" for any market test is tantamount to a finding that Brennan may have breached his duties to Trans Union. *See* RESTATEMENT (SECOND) OF AGENCY § 381 (1958) (requiring disclosure of information "relevant to affairs entrusted to [the agent]").

47. *Smith*, 488 A.2d at 879.

48. *Id.* at 888. Of course, a merger agreement signed by a CEO after board authorization, that is not subsequently repudiated by the board, would bind the corporation in important aspects. Indeed, just a short time after the Trans Union transaction with Pritzker, Texaco was forced into bankruptcy after a court allowed a claim for tortious interference with contract in a similar scenario. *See* Janet Elliott, *Lasting Impact; Legal Anomaly; A Look Back at the Real Trial of the Century*, TEX. LAW., Dec. 18, 1995, at 1. Thus, Van Gorkom's belief that signing agreements had little legal effect seems misguided at best. In fact, at least one prospective bidder refused to bid against Pritzker unless the agreement were rescinded; when Pritzker refused, the bidder withdrew. *Smith*, 488 A.2d at 870.

49. *Id.* at 882.

50. *Id.*

51. *Id.* at 883. "[T]he amendments were considerably at variance with [board authorization]." *Id.* at 870. As such, it would appear that Van Gorkom exceeded his authority through negligent—if not reckless—misconduct, and that the board could have pursued a claim against Van Gorkom for violation of his duty of obedience. *See* RESTATEMENT (SECOND) OF AGENCY §§ 383, 385 (1958).

52. *Smith*, 488 A.2d at 883.

53. *Id.* at 879.

54. *Id.* at 883. "Pritzker delivered . . . the proposed amendments to the September 20 [m]erger [a]greement. Van Gorkom promptly proceeded to countersign all the instruments on behalf of Trans Union without reviewing the instruments to determine if they were consistent with the authority previously granted him by the [b]oard." *Id*.

55. *See supra* notes 33-34, 36, 44, 46, 51, 54 and accompanying text.

The court's disposition of the motions for reargument demonstrates why the corporation never pursued possible claims against Van Gorkom and Brennan.[56] The court granted director-defendant Thomas P. O'Boyle leave for new counsel, who then moved individually for rehearing.[57] O'Boyle's new counsel argued that O'Boyle should be considered individually because certain facts applied only to him.[58] The court rejected this argument as not timely asserted.[59]

Prior to filing the motions for reargument, counsel for *all* defendants—Van Gorkom and the entire board—told the Delaware Supreme Court at oral argument that no basis existed for distinguishing between Van Gorkom and the outside directors in terms of liability.[60] The fact that the court specifically inquired into this issue suggests some opportunity for the outside directors to distance themselves from their errant CEO.[61] In fact, the court raised this question after it extended to the outside directors a "special opportunity" to present any legal or factual arguments why any defendant should be treated individually.[62] Thus, the court premised its disposition of the case on the fact that the joint defense "required [the court] to treat all of the directors as one."[63] Given the depths of Van Gorkom's negligence, the most reckless decision of the outside directors may have been joining their defense to Van Gorkom, particularly if we assume that they were fully advised of the benefits and costs of so proceeding.[64]

This is not to say that facts supporting the liability of the outside directors separate and apart from Van Gorkom did not exist. The directors committed to selling the company after meeting for just two hours, without prior notice of the nature of the meeting, and based their decision primarily upon a twenty-minute presentation from Van Gorkom.[65] They too failed to read the operative agreements, acted without any written summary of the transaction, and failed to assure that the agreements were in accordance with their prior approval.[66] In fact, they acted in a "total absence of any documentation whatso-

56. *See Smith*, 488 A.2d at 898-99.
57. *Id.* at 898.
58. *Id.*
59. *Id.*
60. *Id.* at 899.
61. *See id.*
62. *Id.* at 898-99.
63. *Id.* at 899.
64. Presumably, the joint defense would have triggered the applicability of a conflict of interest analysis, along with the requirement that defense counsel obtain the informed consent of each defendant. *See* MODEL RULES OF PROF'L CONDUCT R. 1.7 (2003). To the extent the outside directors participated in a joint defense with Van Gorkom, they may be deemed to have ratified or condoned Van Gorkom's failure to assure that the agreements as executed accorded with the transaction they approved. RESTATEMENT (SECOND) OF AGENCY §§ 83-84 (1958) (stating that affirmance of a transaction gives rise to ratification).
65. *Smith*, 488 A.2d at 874. The court thought the hurried consideration was inappropriate in the absence "of a crisis or emergency." *Id.*
66. *Id.* at 874, 878.

ever."[67] Finally, it does not appear that the board was sufficiently inquisitive regarding the transaction; the board did not ask questions about Van Gorkom's basis for the price or other key elements of the transaction.[68] Notwithstanding these facts, Van Gorkom individually botched the auction for the company—the most central cause of harm to Trans Union's shareholders.[69] Given this core fact, it would seem that the court overextended the definition of gross negligence to the entire board.[70] At the very least, the mere negligent conduct of the board should not trigger liability for "gross negligence."[71]

We will never know whether the outside directors would have been liable if represented by their own counsel. We also will never know if the outside directors could have successfully cross-claimed against Van Gorkom or impleaded claims against attorney Brennan primarily because of the joint defense.[72] Still, both the lower court as well as two Delaware Supreme Court Justices believed that the defendants were not grossly negligent.[73] Moreover, at least one commentator raised the possibility that the directors may have been victims of attorney malpractice.[74] Counsel Brennan advised the board that they did not need a fairness opinion to support their decision and that they would potentially face a lawsuit if they failed to approve the transaction; however, the fairness opinion would have helped in their defense when the board was ultimately sued for approving the transaction.[75] Unfortunately, the joint defense precluded the full presenta-

67. *Id.* at 875.

68. *Id.* at 874, 877.

69. In fact, an actual offer of $60 per share was made, only to be withdrawn in the wake of Van Gorkom's "completely negative" reaction. *Id.* at 884-85. This offer substantially exceeded the amount per share yielded by ultimate settlement of the case. *See* EISENBERG, *supra* note 34, at 561 (reporting settlement of $23.5 million); *Smith*, 488 A.2d at 864 n.3 (stating that there were about 13 million Trans Union shares outstanding). Some commentators argue in favor of restricting officer liability. *See* Dennis R. Honabach, Smith v. Van Gorkom*: Managerial Liability and Exculpatory Clauses—A Proposal to Fill the Gap of the Missing Officer Protection*, 45 WASHBURN L.J. 307 (2006). Van Gorkom's misconduct should give pause to those arguing in favor of such an approach.

70. In tort parlance, it would appear that Van Gorkom's botching of the auction was an intervening cause that could potentially operate as a superceding cause of the harm to the shareholders. DAN B. DOBBS, THE LAW OF TORTS § 186 (2000) (stating that an intervening cause is one that occurs after a given defendant's conduct, and that a superceding cause—one that is the immediate or efficient cause—can relieve the defendant of liability).

71. "If enough fact finders in enough close cases are instructed they must find gross rather than ordinary negligence, there will be in all likelihood a greater number of defense verdicts." GEVURTZ, *supra* note 7, at 286.

72. Brennan's firm represented defendants in the litigation. *Smith*, 488 A.2d at 880. The rules of professional responsibility preclude an attorney from representing parties with directly adverse interests. MODEL RULES OF PROF'L CONDUCT R. 1.7 (2003). Thus, the attorney representing all of the defendants in *Smith* could not counsel the outside directors regarding potential wrongdoing by Van Gorkom or Brennan.

73. *See Smith*, 488 A.2d at 894 (McNeilly, J., dissenting); *id*. at 898 (Christie, J., dissenting).

74. GEVURTZ, *supra* note 7, at 296 n.60 (stating that counsel's "failure to warn the directors that they were about to breach their duty by acting on inadequate information clearly raises the issue of malpractice").

75. *Smith*, 488 A.2d at 868. It would have been particularly helpful if the directors had supported their position with a fairness opinion to guide their negotiations with the acquirer,

tion of this claim because Brennan was a member of the defense firm in the *Smith* litigation.[76] It is doubtful that the outside directors would have been found grossly negligent if they had distanced themselves from Van Gorkom and asserted claims against attorney Brennan.[77]

Regardless of whether the outside directors would have been found grossly negligent if defended individually, the fact remains that they did pursue a joint defense with Van Gorkom. The news of their liability supposedly shocked the business leadership community, as well as the insurance industry, leading to a concerted effort to eliminate duty-of-care liability.[78] Shortly after the *Smith* decision, Delaware enacted section 102(b)(7) of the Delaware General Corporation Act,[79] which for the first time permitted management to disclaim liability for monetary damages for the breach of the duty of care through a provision in the corporate charter.[80] These provisions spread throughout the United States, and today the vast majority of states have provisions that in varying degrees diminish, or completely eliminate, liability for breach of the directors' duty of care.[81] The breadth of these provisions is often such that even an infinitely negligent director—a director who does absolutely nothing—like the defendant in *Francis v. United Jersey Bank*,[82] would not be liable for monetary damages to the corporation.[83] In terms of public corporations, ac-

rather than simply to justify the ultimate price. *See supra* note 37. Thus, counsel's advice was at best misleading and incomplete. Similarly, because the directors faced potential suits regardless of their decision, both parts of counsel's advice were misleading and incomplete.

76. *Smith*, 488 A.2d at 880.

77. Other commentators have opined that the facts of *Smith* support a finding of gross negligence, without explicitly considering the possibility of an independent defense. *See supra* notes 1, 6.

78. GEVURTZ, *supra* note 7, at 315-16.

79. DEL. CODE ANN. tit. 8, § 102(b)(7) (2001).

80. *Id.* According to Professor Steinberg, it took only "a few months" for clamoring corporate fiduciaries to prevail upon the Delaware legislature to pass the insulating statute. Steinberg, *supra* note 8, at 920.

81. *See* Hanks, *supra* note 15.

82. 432 A.2d 814, 820 (N.J. 1981) (holding a director who "never made the slightest effort to discharge any of her responsibilities" liable for breach of the duty of care).

83. There are only four exceptions to the insulating effect of section 102(b)(7). Directors may still be liable for monetary damages for: 1) breach of the duty of loyalty; 2) acts or omissions not in good faith; 3) unlawful dividends; and 4) transactions in which the director received an improper benefit. DEL. CODE ANN. tit. 8, § 102(b)(7). Delaware law states the following:

> A failure to act in good faith may be shown, for instance, where the fiduciary intentionally acts with a purpose other than that of advancing the best interests of the corporation, where the fiduciary acts with the intent to violate applicable positive law, or where the fiduciary intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties.

In re Walt Disney Co. Derivative Litig., No. 15452, slip op. at 124-25 (Del. Ch. Aug. 9, 2005), *available at* http://courts.delaware.gov/opinions/(ymaqvrn5bplq3n45izvbwx55)/download.aspx?ID=64510. It is notable that this formulation of good faith requires intentional wrongdoing. Notwithstanding the legal rhetoric, and in contrast to Professor Bishop's 1968 finding of few cases of liability, no director has been found to have been liable for breach of the duty of care since the *Smith* decision. Bernard S. Black, Brian R. Cheffins & Michael Klausner, *Outside Director Liability* 6 (Stanford Law & Econ. Olin Program, Working Paper No. 250, 2003), *available at* http://law.bepress.com/cgi/viewcontent.cgi?article=1011&context=alea.

cording to Professor Lawrence A. Hamermesh, a very high percentage have eliminated duty-of-care liability pursuant to a charter provision authorized under section 102(b)(7) or similar provisions under other state laws.[84] Thus, these statutes have rendered claims for breach of the duty of care "essentially obsolete."[85] "The evisceration of the duty of care is a drastic step in the corporate governance framework. . . . Such expansionist state legislation . . . may portend the development that states and corporate fiduciaries fear—the adoption of federal legislation."[86]

In the end, the *Smith* decision itself seems to have left corporate law and the duty of care where it began.[87] If the duty of care means anything in the context of corporate fiduciaries, it must at a minimum mean that such fiduciaries should not sign high-stakes agreements without reading them or comprehending their terms.[88] Van Gorkom did this, and the board condoned it by joining his defense; finding liability under these facts should have been as shocking as finding gambling at Rick's *Café Americain*.[89] *Smith* cannot be termed a major change in the law or in the risks facing directors, particularly outside directors who, unlike the directors in *Smith*, effectively distance themselves from errant CEOs.[90] Indeed, aside from giving real meaning to the term "gross negligence," by finding some directors liable, the case seems unremarkable, except to illustrate the risks of pursuing a joint defense strategy with a very negligent individual.[91] Understood

84. *Why I Do Not Teach* Van Gorkom, *supra* note 12, at 490 (finding that 98% of sampled Fortune 500 companies that incorporated under state laws that permit insulation of directors for duty-of-care liability had adopted insulating charter provisions, and that 100% of Delaware firms sampled had adopted such provisions).

85. *Id.*

86. Steinberg, *supra* note 8.

87. *See, e.g.*, Gimbel v. Signal Cos., Inc., 316 A.2d 599 (Del. Ch. 1974) (finding that the business judgment rule did not protect directors who recklessly accepted a "grossly inadequate" price for the sale of the company), *aff'd*, 316 A.2d 619 (Del. 1974); Penn Mart Realty Co. v. Becker, 298 A.2d 349 (Del. Ch. 1972) (holding that allegations of gross negligence against directors stated a claim). The concept that directors could be held liable for negligence was hornbook law in 1985. *See* HARRY G. HENN & JOHN R. ALEXANDER, LAWS OF CORPORATIONS § 234 (3d ed. 1983) (stating that "negligence . . . precludes application of the 'business judgment' rule").

88. This apparently occurred twice. First, Van Gorkom signed the original merger agreement without reading it. Smith v. Van Gorkom, 488 A.2d 858, 869 (Del. 1985). Second, with respect to the amendments to the merger agreement, "Van Gorkom promptly proceeded to countersign all the instruments . . . without reviewing [them] to determine if they were consistent with the authority previously granted him by the Board." *Id.* at 883. Van Gorkom's misconduct "had the . . . effect of locking Trans Union[ ] . . . into the Pritzker [a]greement." *Id.* at 884.

89. I refer to the scene from *Casablanca*, where Captain Renault expresses shock at finding gambling at Rick's *Café Americain*, at the moment he collects his winnings. CASABLANCA (Warner Bros./First National 1942).

90. *See* Schwartz & Wiles, *supra* note 2, at 430 ("We disagree with the suggestion that the [*Smith*] holding is 'new law.' . . . [W]e contend the case merely represents a reiteration of existing Delaware law."); *see also* Steinberg, *supra* note 8, at 919 n.3 (collecting authorities assessing the novelty of *Smith*).

91. If anything, liability for negligent directing was not expansive enough before *Smith. See* Bishop, *supra* note 19, at 1099 ("The search for cases in which directors of industrial corporations have been held liable . . . is a search for a very small number of needles in a very large haystack."). Professor Bishop was no friend of efforts by management to insulate themselves

through the lens of the motion for reargument, *Smith* thus raises the question: If it does not stand for a major change in law and therefore does not materially enhance the risks facing directors, then why did it spur such a "drastic" response in terms of corporate governance?[92] This article asserts that the duty of care for corporate directors fell to the special interest influence of business managers, resulting in an economically sub-optimal corporate governance regime.

III. WHAT HAS *SMITH* WROUGHT?

Part II demonstrated that the reaction to *Smith* was overblown, in the sense that the evisceration of the duty of care within public corporations was a radical change in the nation's corporate governance regime, and nothing in *Smith* was a sufficient basis for drastic change. This part will seek to demonstrate that in the wake of *Smith*, insulating legislation in the form of statutes such as section 102(b)(7) are economically sub-optimal[93] and therefore create pressure for further legal response.[94]

There are many indications that the legacy of *Smith* is in fact an economically sub-optimal result. First, there is evidence suggesting that investors pay less for shares in companies that insulate their directors from liability for duty-of-care provisions and for shares in corporations operating under governance regimes that permit such

from liability and would have looked askance at section 102(b)(7): "In sum, I think that the practice of protecting corporate executives against litigation and liability has now been carried about as far as it ought to be carried and perhaps a little farther." *Id.* at 1103. He specifically concluded that directors and officers should be held liable for those rare instances of "gross negligence." *Id.* He also noted that many corporate fiduciaries had historically been held liable for breaching the duty of care, particularly in bank cases. *Id.* at 1095-96. In all, Professor Bishop finds numerous cases holding boards answerable for some form of negligence, but with a relatively limited frequency, including "four such specimens" he terms "recent." *Id.* at 1099; *see also supra* note 82.

92. *See* Steinberg, *supra* note 8, at 928-29.

93. I use the term "economically sub-optimal" in both a microeconomic and macroeconomic sense. From a microeconomic efficiency perspective, if investors face more risks of diversion—or excessive agency costs—in investing in equity markets, then it will be more costly to entice them to invest. Thus, the risk that managers will exploit infinitely careless boards to expropriate higher compensation will naturally lead to an unnecessarily higher cost of capital within corporate America or will cause investors to supply capital on less favorable terms. *See* Castro, et al., *supra* note 8, at 1131-35, 1166-68. Managers are likely to exploit boards if the legal infrastructure surrounding the corporation encourages a void in board diligence. The excess cost of capital will lead to fewer wealth-enhancing investment transactions. Macroeconomically, growth will be impaired in any nation that permits an excessive cost of capital because of the crucial role that capital accumulation and innovation play in macroeconomic performance. Steven A. Ramirez, *Fear and Social Capitalism: The Law and Macroeconomics of Investor Confidence*, 42 WASHBURN L.J. 31, 41-42 (2002); *see also* Schwartz & Wiles, *supra* note 2, at 445 ("There are additional purposes to be served by the evolution . . . of American . . . corporate law, besides those of pure economic efficiency and the minimization of transaction costs. One is to insure the continued confidence of investors . . . . The rules of law relied upon in [*Smith*] admirably serve that function.").

94. Professor Steinberg predicted this result soon after the race to permit infinitely careless directors commenced. *See supra* text accompanying note 86.

insulation.[95] Second, one study assessed the influence of twenty-four key elements of corporate governance, including the presence of provisions insulating directors from duty-of-care liability, upon stock market valuation. The study found that companies with inferior corporate governance were valued at inferior levels.[96] The economic sub-optimality of eliminating the duty of care for directors further undercuts any argument that shareholders approve such charter amendments in any meaningful fashion; management simply exerts too much control over the proxy process to assume shareholders are approving such economically destructive provisions.[97] Further evidence of the sub-optimality of *Smith*'s legacy is found in the executive compensation arena, when the carelessness of directors manifests itself in enhanced power and soaring executive compensation levels for CEOs.[98]

Executive compensation in the United States has long been a point of scholarly debate. An overview of the legal context of executive compensation is necessary to understand the fundamentally CEO-indulgent legal framework governing compensation decisions. First, the business judgment rule operates to insulate compensation issues from any searching judicial review.[99] Second, compensation decisions have traditionally enjoyed an even higher degree of such insulation.[100] Third, if compensation is approved by shareholders, the decision will invariably stand, essentially immune from judicial review.[101] Fourth, votes to secure shareholder approval are manipulated in favor of management in many powerful ways.[102] Fifth, CEOs,

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95. Bradley & Schipani, *supra* note 17.

96. Paul Gompers, Joy Ishii & Andrew Metrick, *Corporate Governance and Equity Prices*, 118 Q.J. ECON. 107, 107 (2003). There is also little basis for concluding that Delaware law generally has a positive effect on firm value. *Id.*; Guhan Subramanian, *The Disappearing Delaware Effect*, 20 J.L. ECON. & ORG. 32, 33 (2004) (finding that while there is evidence that smaller Delaware firms have enjoyed enhanced value at times, this effect has disappeared at other times, and is non-existent for "larger firms, which comprise 98% of the sample" of Delaware firms; "[t]hus the Delaware effect 'disappears' when examined over time and when examined for firms that are economically meaningful"); *see also* Ramirez, *supra* note 14, at 572 ("[I]nvestors neither care about nor have the ability to judge the state of incorporation and the impact that this has either upon their rights or profits. There is therefore little empirical evidence showing that markets integrate a state of incorporation or change in corporate governance into stock prices.").

97. Steinberg, *supra* note 8, at 927; *see infra* notes 102-03.

98. Joel Seligman, *Rethinking Private Securities Litigation*, 73 U. CIN. L. REV. 95, 113-15 (2004). Seligman asserted that lax state fiduciary duties contributed to "a dramatic increase in the ratio of the compensation of the corporate CEO to that of the average corporate blue collar employee. In 1980, this ratio was 42 to 1; . . . by 2000, it was estimated to be at least 475 to 1." *Id.* at 114.

99. Linda J. Barris, *The Overcompensation Problem: A Collective Approach to Controlling Executive Pay*, 68 IND. L.J. 59, 100 (1992) (arguing that courts should cease using the business judgment rule to shield excess compensation in all cases).

100. *Id.* at 82 (stating that in many cases "since the turn of the [twentieth] century, courts have . . . applied the business judgment rule and endorsed the compensation practice").

101. *See* PRINCIPLES OF CORPORATE GOVERNANCE § 5.03 (1992) (requiring a showing of waste to set aside compensation approved by shareholders).

102. *See* Thomas W. Joo, *A Trip Through the Maze of "Corporate Democracy": Shareholder Voice and Management Composition*, 77 ST. JOHN'S L. REV. 735 (2003). Professor Joo identifies the following impediments to shareholder voting power: federal proxy rules that prohibit inclu-

who generally control board membership, are in no way impaired in selecting compensation committee members, who for a variety of social and cultural reasons are likely to be very sympathetic to claims for higher, more generous compensation packages.[103] After *Smith*, absolute non-liability for monetary damages may be included in this very pro-CEO legal framework with respect to compensation issues.[104] Given this framework, it should come as no surprise that executive compensation has soared since *Smith.*[105] Simply stated, *Smith*'s legacy has allowed agency costs to run amok.[106]

These agency costs transcend excessive compensation. The compensation package that often led to the highest pay-outs, the option plan, created perverse incentives at the height of the public corporation in America.[107] These incentives encouraged officers to fraudulently manipulate and inflate their share prices.[108] Thus, many commentators suggest that the compensation crisis fueled the recent series of corporate scandals.[109] According to respected business leaders, these incentives operated to create a historic crisis in investor confidence, which had macroeconomic significance.[110] "Boards of directors became lax in performing their historical duty to monitor com-

sion of shareholder proposals relating to board membership within management's proxy, meaning dissident shareholders must bear the steep costs of their own proxy challenge; and authorization of brokers to vote shares within client accounts—invariably voting with management—unless they receive contrary instructions. *Id.* at 758-60.

103. Steven A. Ramirez, *Games CEOs Play and Interest Convergence Theory: Why Diversity Lags in America's Boardrooms and What to Do About It*, 61 WASH. & LEE L. REV. 1583, 1589-91 (2004). One commentator has stated that the incidence of electoral challenges to incumbent management is "extremely rare" and that the incidence of successful challenges is "practically negligible." Lucian Arye Bebchuk, *The Myth of the Shareholder Franchise* (Nat'l Bureau of Econ. Research, Oct. 2005), *available at* http://ssrn.com/abstract=829804.

104. *See supra* note 83.

105. Bebchuk & Grinstein, *supra* note 16, at 283 (showing that executive compensation has doubled from 1993 to 2003, as a proportion of profits of the S&P 500); *see also* INST. FOR POLICY STUDIES & UNITED FOR A FAIR ECON., EXECUTIVE EXCESS 1, 4 (2005) (reporting that the ratio of CEO to average worker pay went from 107 to 1 in 1990 to 431 to 1 in 2004).

106. *See* Michael Jensen & William Menkling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 306 (1976) ("It is generally impossible for the principal or the agent at zero cost to ensure that the agent will make optimal decisions from the principal's viewpoint."). The problem of agency costs within the corporation has bedeviled shareholders and scholars from the very incipiency of corporate power. JOHN MICKLETHWAIT & ADRIAN WOOLDRIDGE, THE COMPANY xviii (2003).

107. *See* Douglas Guerrero, *The Root of Corporate Evil*, INTERNAL AUDITOR, Dec. 2004, at 37 ("It appears that . . . highly placed executives used their power . . . to achieve financial targets fraudulently, boost the stock price, and further enrich themselves via compensation schemes that rewarded those achievements.").

108. *Id.*

109. *See Federal Reserve Board's Semiannual Monetary Policy Report to the Congress: Hearing Before the Comm. on Banking, Housing, & Urban Affairs*, 107th Cong. (2002) (testimony of Chairman Alan Greenspan), *available at* http://www.federalreserve.gov/boarddocs/hh/2002/july/testimony.htm (stating that lax boards had contributed to a CEO-centric corporate power structure that permitted senior executives to "harvest" gains through manipulation of share prices).

110. THE CONFERENCE BD., COMMISSION ON PUBLIC TRUST AND PRIVATE ENTERPRISE 6 (2003) (finding that excessive compensation, resulting in part from lax monitoring by boards, led to an "unprecedented" loss of investor confidence).

pensation."[111] The problem of excessive compensation further demonstrates that the destruction of the duty of care cannot be economically justified. It materially contributed to the macroeconomic instability arising from the failure of Enron, WorldCom, Tyco, Global Crossing, and others during 2001 and 2002.[112]

I do not argue, however, that *Smith* alone led to these scandals. There is no logical reason why special influence would be so neatly contained within the doctrine of the duty of care. Instead, *Smith*'s legacy is found in the Private Securities Litigation Reform Act of 1995 (PSLRA),[113] which has been identified as a prime example of the use of campaign contributions to influence the law.[114] The accounting industry and the high-tech sector backed the PSLRA by funding a $29.6 million war chest.[115] "[T]he PSLRA merely rigs private securities claims so that defendants almost always win."[116] Commentators have noted other elements of state law which tilted the field in favor of management and against shareholders.[117] Former Securities and Exchange Commission Chair Arthur Levitt has further catalogued a series of battles he waged in the 1990s against monied interests in efforts to protect investor rights and hold management more accountable.[118] The influential voice of management and affiliated groups prevailed, and the rights of shareholders were restricted at virtually every turn.[119] *Smith*, therefore, sparked changes in the legal structure of the corporation that effectively passed massive power from shareholders

111. *Id.*

112. Seligman, *supra* note 98, at 112-16 (identifying lax state fiduciary standards, along with the Private Securities Litigation Reform Act of 1995 (PSLRA), as key legal elements underlying the corporate scandals of 2001 to 2002).

113. Pub. L. No. 104-67, 109 Stat. 737 (codified as amended in scattered sections of 15 U.S.C.).

114. Ann Reilly Dowd, *Look Who's Cashing in on Congress*, MONEY, Dec. 1997, at 128, 132 (listing the PSLRA as the top example of how money drives legislation).

115. *Id.*; *see also* Douglas M. Branson, *Running the Gauntlet: A Description of the Arduous, and Now Often Fatal, Journey for Plaintiffs in Federal Securities Law Actions*, 65 U. CIN. L. REV. 3, 24 (1996) (stating that money from accounting and high tech industries backed the PSLRA).

116. Ramirez, *supra* note 10, at 1093. Since the PSLRA, courts have dismissed a greater percentage of securities cases and not a single one had made it to trial as of 2002. Seligman, *supra* note 98, at 112.

117. *See, e.g.*, Joel Seligman, *The Case for Federal Minimum Corporate Law Standards*, 49 MD. L. REV. 947, 949 (1990) ("The most distinctive aspect of the last decade in corporate law was the celerity with which traditional constraints on corporate managers weakened.").

118. ARTHUR LEVITT, TAKE ON THE STREET 106-15 (2002) (recounting how "the business lobby" and "CEOs" successfully used Congress and the SEC to thwart an effort by the Financial Accounting Standards Board to require that options be expensed on corporate income statements).

119. Levitt details one hard-fought investor victory, the independence of the Financial Accounting Foundation, which oversees the promulgation of accounting standards. *Id.* at 111-15. Levitt acknowledges, however, that such victories were dwarfed by setbacks such as the one suffered when the SEC attempted to secure auditor independence. *Id.* at 127. Levitt recounts in great detail his struggle to impose greater auditor independence upon the accounting industry; ultimately, he had to settle for watered-down rules that the industry found acceptable, after Congress threatened the SEC with budget cuts. *Id.* at 127-39. The relationship between auditor Arthur Andersen and Enron is one example of the importance of auditor independence. Enron failed amidst a sea of accounting scandals. An independent auditor may have mitigated this

to CEOs.[120] This transfer of power, exemplified in voting control over the corporation and compensation paid to top executives, created a CEO-primacy model of corporate governance.[121]

The recently enacted Sarbanes-Oxley Act has also failed to remedy the deficiencies left in the wake of *Smith*.[122] In fact, there is a growing consensus that this Act rests upon an unstable policy foundation.[123] The Act does not restore the duty of care and does virtually nothing to directly limit executive compensation.[124] Rather, the Act seems to rely on criminal law by imposing harsh sentences on executives convicted of white-collar crimes.[125] Even if criminal sanctions are properly calibrated such that the punishment fits the crime, it is doubtful that such sanctions alone can provide sufficient deterrence.[126] Thus, while the macroeconomic threats posed by the meltdown in investor confidence from the summer of 2002 have subsided, the underlying risks that led to that market dysfunction remain unabated.[127] Events since the passage of the Act support this central point.

disaster. Andersen actually received more in consulting fees ($27 million) than audit fees ($25 million). *Id.* at 139-43.

120. Naturally, the politics and ideology of the current governing coalition is a material factor in the content of any legal changes. *See* Seligman, *supra* note 98, at 100 ("After the Republican Party gained control of both houses of Congress in the 1994 elections, the movement for private securities litigation reform took on a greater urgency. An earlier debate about whether empirical evidence justified curtailing the private securities class action was succeeded by the triumphant certitude of an ideological majority.").

121. *See supra* notes 16, 102-03.

122. *See* Inst. for Policy Studies & United for a Fair Econ., *supra* note 105, at 1 (showing that in 2003 executive compensation was 301 times the pay for an average worker, while in 2004 it was 431 times the average worker's pay).

123. Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 Yale L.J. 1521, 1594 (2005) (stating that the Sarbanes-Oxley Act corporate governance reforms were costly and "poorly conceived").

124. Ramirez, *supra* note 93, at 67.

125. *See* Mary Kreiner Ramirez, *Just in Crime: Guiding Economic Crime Reform After the Sarbanes-Oxley Act of 2002*, 34 Loy. U. Chi. L.J. 359, 410-11 (2003) (providing an overview of the criminal provisions of the Sarbanes-Oxley Act and concluding that cultural factors may still operate to dilute law enforcement efforts). I am skeptical that law enforcement resources will continue to be devoted to white-collar crime in a fashion that would assure a constant deterrent effect. In addition, given that the United States has the highest incarceration rate in the world, any further criminalization must be deemed suspect. *See Growth of U.S. Prison Population Slows*, USA Today, Oct. 24, 2005, at 3A, *available at* http://archives.cnn.com/2000/US/08/09/prison.population/ (stating that U.S. incarceration rate of 724 per 100,000 is 24% higher than any other nation, and that young black men are seven times more likely to be incarcerated than young white men).

126. At best, relying on criminal sanctions over private litigation is a relatively untested approach. *See also* Seligman, *supra* note 98, at 137 (arguing that criminal enforcement is not usually appropriate for assuring sound corporate accountability because sanctions must be "calibrated to the nature of the violation").

127. *Id.* ("Only when boards consistently believe they have something to lose from quiescence are they likely to be a fully effective check on self-interested or non-law-compliant senior management.").

For example, in the fall of 2005, the largest independent futures broker in the United States suffered a catastrophic "flameout."[128] The CEO of Refco Group Limited concealed $430 million in debts that he owed Refco through entities under his control, leading to his indictment for securities fraud.[129] Refco had just consummated an initial public offering of its shares in August of 2005, raising $583 million.[130] This public offering would have triggered the full applicability of the Sarbanes-Oxley Act, but not until the company filed its periodic reports.[131] Refco was also a member of the Chicago Mercantile Exchange and was therefore regulated by the Commodities Futures Trading Commission.[132] The SEC exercised supervisory authority over the Refco public offering as well as the Refco securities brokerage units.[133] Moreover, the audit firm of Grant Thornton was required to audit the firm's books in accordance with the new Sarbanes-Oxley regime governing audits of public firms.[134] Finally, numerous underwriters, including Bank of America, Goldman Sachs, and Credit Suisse First Boston, would each have been subject to the "due diligence" requirements of federal securities laws, as would have any other professionals associated with the public offering such as the firm's legal counsel.[135] Yet, despite abundant oversight and the applicability of the Sarbanes-Oxley reforms, hundreds of millions of dollars in bad debts owed by the firm's CEO were not uncovered before thousands of public investors were fleeced of over $1 billion.[136] The message to public investors is that "[t]here is no way you can rely on an auditor or an investment bank for a seal of approval or a guarantee of no chicanery . . . . The lesson to be learned from Refco is that you must do sleuth work yourself."[137]

It is difficult to imagine a more inefficient reality or a more dangerous source of macroeconomic instability.[138] Essentially, public in-

128. Peter Robison, *Bennett's Refco Scheme Exposed by Late-Night Hunch: "It Hit Me*," BLOOMBERG.COM, Oct. 27, 2005, http://quote.bloomberg.com/apps/news?pid=10000103&sid=aKGJd31_yYQM&refer=news_index#.

129. Susan Diesenhouse, *Ex-CEO Charged in Refco Scandal*, CHI. TRIB., Oct. 13, 2005, § 3, at 1.

130. *Id.*

131. Michael Rapoport, *Moving the Market—Tracking the Numbers/Outside Audit: Refco's Sarbanes-Oxley Loophole*, WALL ST. J., Oct. 24, 2005, at C3.

132. Susan Diesenhouse, *Refco's Fall Continues; Brokerage Unit to Shut*, CHI. TRIB., Oct. 15, 2005, § 3, at 1.

133. *Id.*

134. Jim Peterson, *Who to Blame for Refco?*, INT'L HERALD TRIB., Oct. 22, 2005, at 15 (calling the Sarbanes-Oxley Act a "gigantic redundancy").

135. Emily Thornton, *Refco: The Reckoning*, BUS. WK. ONLINE, Nov. 7, 2005, http://www.businessweek.com/magazine/content/05_45/b3958095.htm (quoting Professor John Coffee: "[O]ur current system of due diligence by underwriters seems to be dysfunctional").

136. Diesenhouse, *supra* note 129.

137. Thornton, *supra* note 135 (quoting "veteran money manager" Michael F. Holland at Holland & Co.).

138. The efficient market hypothesis is premised upon the fact, or hope, that all material information is impounded into market prices. If investors cannot be assured that they have

vestors must do the job of the board in monitoring management and finances of a public company.[139] Investors must find what the board has missed.[140] This harsh, even ridiculous, notion flows directly from the fact that directors may be infinitely careless under the mainstream approach to director duties of care under state corporate law.[141]

The Sarbanes-Oxley Act is a failure.[142] Refco proves that it will not serve to deter careless boards, slovenly management, and collusive expropriation and diversion of shareholder wealth.[143] Indeed, the Act is even worse than a mere failure: It imposes significant costs upon all public firms without regard to whether management and boards are conducting themselves appropriately.[144] These substantial costs have deterred firms from staying public, as well as deterred firms from going public.[145] This can only mean that the Sarbanes-Oxley reforms are both costly and ineffective: The Act is therefore a miserable failure.[146]

This failure was foreseeable.[147] The Act simply ignored the benefits of private litigation.[148] The benefits include the following: the creation of private "incentives to ferret out" fraud that public investigators miss; private enforcement immunity from political influence; the probability that investor remedies are more likely to repair investor confidence than mere criminal or administrative remedies; and the lack of any public financing requirement for enforcement efficacy.[149] There was no recognition of the possibility that the duty of

sufficient information to support investment decisions, the thesis collapses. *See* Eugene F. Fama, *Efficient Capital Markets: II*, 46 J. FIN. 1575, 1575 (1991). Obviously, concealed information hidden from public view, like the loans to the Refco CEO, cannot be impounded into market price. *See* Burton Malkiel, *Efficient Market Hypothesis*, *in* THE NEW PALGRAVE, THE WORLD OF ECONOMICS 211-18 (John Eatwell, Murray Milgate & Peter Newman eds., 1991). Similarly, if investors believe that information is not available or is not sufficiently reliable to support their investment decisions, the additional risks they face from this uncertainty will require compensation, leading to a higher cost of capital and impaired macroeconomic growth. Ramirez, *supra* note 93, at 41-46.

139. Obviously, this is impossible; directors are vested with ultimate management power and investors are not. *E.g.*, DEL. CODE ANN. tit. 8, § 141(a) (2001). In addition, directors have broad information rights within the corporation. *E.g.*, PRINCIPLES OF CORPORATE GOVERNANCE § 3.03 (1992). Shareholders have more limited information rights that frequently require a court action to pursue. *E.g.*, Saito v. McKesson HBOC, Inc., 806 A.2d 113, 118 (Del. 2002) (holding that a shareholder must show "the documents are necessary and essential to satisfy the stockholder's proper purpose" for examining corporate books and records).

140. *See supra* note 83.

141. *See supra* notes 15, 83.

142. The central purpose of the Sarbanes-Oxley Act was "to protect investors by improving the accuracy and reliability of corporate disclosures." H.R. REP. NO. 107-610, at 1 (2002) (Conf. Rep.), *as reprinted in* 2002 U.S.C.C.A.N. 542, 542.

143. *See supra* notes 128-37 and accompanying text.

144. *See* Romano, *supra* note 123, at 1587-89.

145. *Id.* at 1589.

146. *A Price Worth Paying?*, ECONOMIST, May 19, 2005, *available at* http://www.economist.com/business/displayStory.cfm?story_id=3984019 (reporting that a survey of CFOs found that on average firms were paying $2.4 million more for audit services after Sarbanes-Oxley).

147. Ramirez, *supra* note 93, at 64 (raising the prospect that the Sarbanes-Oxley Act may be "a political fraud on the investing public").

148. *Id.* at 63-65.

149. *Id.* at 65.

care could be reinvigorated.[150] The Sarbanes-Oxley Act ignored a fundamental economic maxim: "When a legal actor runs a risk of liability, the legal actor is most likely to carefully weigh the consequences of each professional judgment."[151] This is true even though duty-of-care litigation does not impose costs to all public companies.[152] By any reasonable analysis, duty-of-care liability was exceptional.[153] Nevertheless, many experts recognized the centrality of careless directors to virtually all of the major corporate scandals driving the Sarbanes-Oxley reform effort.[154] Indeed, even noted business leaders admitted that a "massive failure in corporate governance" occurred in the first few years of this century, as "too many directors don't take their responsibilities seriously."[155] A limited notion of duty-of-care liability can hardly be termed untested;[156] it had been the law for decades.[157]

A full analysis of the costs of a CEO-centric model of corporate governance must account for foreseeable events such as the Sarbanes-Oxley Act.[158] Once the law was fully twisted into a CEO-primacy regime, it was only a matter of time before a major crisis would explode; such a regime is economically unsustainable because it will lead to high agency costs, diversion, and impaired investor confidence.[159] Specifically after the PSLRA, it was clear that the Sarbanes-Oxley Act was "a betrayal of the policy foundations of the federal securities laws

150. *See id.* at 62-65.

151. Seligman, *supra* note 98, at 126.

152. The concern is that directors that are essentially un-tethered to any duty-of-care incentive will not expend sufficient effort to be careful when the benefits of that effort flow to shareholders generally. *See* Ramirez, *supra* note 93, at 61-62.

153. *See supra* notes 19, 82, 87, 90-91.

154. "Go back to all of those corporate scandals, and it comes down to a board that missed warning signals." Kurt Eichenwald, *In String of Corporate Troubles, Critics Focus on Boards' Failings*, N.Y. TIMES, Sept. 21, 2003, at A1 (quoting Charles Elson, director of the Weinberg Center for Corporate Governance at the University of Delaware). Indeed, "sleepy" boards have become "commonplace" across America; the onset of provisions such as section 102(b)(7) gave legal sanction to such careless boards; thus, sleepy boards should be expected. *Id.* at A30 (quoting Stephen Davis, president of Davis Global Advisors, a global corporate governance consulting firm).

155. Carol Hymowitz, *How to Fix a Broken System*, WALL ST. J., Feb. 24, 2003, at R1 (quoting former Medtronic CEO William W. George, who also serves on the board of three major public firms).

156. The argument in favor of a more searching, ordinary negligence standard of liability is logically compelling. *See, e.g.*, GEVURTZ, *supra* note 7, at § 4.1.3. No commentator has effectively explained why other professionals should be held liable for professional negligence, but directors should not. *Id.* Nevertheless, in the absence of empirical data in favor of an ordinary negligence standard of liability, it is doubtful that a narrow window of liability, like that which existed before *Smith*, is economically unsound. The pre-*Smith* approach, combined with more generous remedies for investors under the federal securities laws, seems to have controlled agency costs and secured investor confidence from 1934 through the 1990s. Ramirez, *supra* note 93, at 60 n.168.

157. *See supra* notes 19, 82, 87, 90-91.

158. *See* Stuart Banner, *What Causes New Securities Regulation? 300 Years of Evidence*, 75 WASH. U. L.Q. 849, 850 (1997) (finding that scandals and market disruptions generally lead to new financial legislation).

159. *See supra* notes 9-10, 16, 83, 93, 102-03, 105-06, 122.

and a threat to the long term stability of our securities markets."[160] Professor Marc I. Steinberg made a similar prediction regarding the evisceration of the duty of care.[161] It is difficult to justify the obliteration of the duty of care or a CEO-primacy model of corporate governance on economic grounds; no empirical evidence suggests that permitting directors to be infinitely negligent is economically sound.[162] On the other hand, there are strong economic, particularly macroeconomic, reasons for concluding that some duty-of-care obligation makes economic sense.[163] Moreover, history suggests that too much management power, without appropriate limitations on discretion, could impose macroeconomically catastrophic costs.[164]

Given the lack of any economic foundation, the lack of any other rational policy foundation, and the circumstances surrounding *Smith*,[165] special interest influence remains as the only plausible explanation for the evisceration of the duty of care.[166] The Delaware legislature acknowledged that the insurance industry's purported crisis was a central concern when it added section 102(b)(7), amending the Delaware General Corporation Act.[167] No commentator predicted the revolution in corporate governance that occurred after *Smith.*[168] This unpredictable outcome was amplified by America's system of corporate federalism, with Delaware acting early to preserve its position as the leading jurisdiction for public companies, and dozens of states following Delaware.[169]

Our system of corporate governance—buffeted as it is by macroeconomic events, special interest influence, corporate federalism, and even international competitive pressures—defies prediction and is not always subservient to the underlying policy dynamics that

160. Ramirez, *supra* note 10, at 1093.
161. Steinberg, *supra* note 8.
162. BAINBRIDGE, *supra* note 29, at 241-304. Professor Bainbridge offers a theoretical construct suggesting that *Smith* created incentives for transactions that are "over-processed" because directors can spend other people's money to protect themselves from liability. *Id.* at 282. The converse is also true: Directors who are allowed to be infinitely negligent will have diminished incentive to expend time protecting other people's corporate value. Thus, the obliteration of the duty of care will lead to many under-processed transactions. *See supra* note 83.
163. *See supra* notes 107-12 and accompanying text.
164. Seligman, *supra* note 98, at 112-16 (finding that the following factors cumulatively contributed to the "year of scandals" in 2001 to 2002: 1) the underfunding of the SEC; 2) the lax state fiduciary duties governing directors and officers; 3) the compromised integrity of accounting standards; and 4) the PSLRA).
165. GEVURTZ, *supra* note 7, at §§ 4.1.3, 4.1.7 (searching in vain for a policy basis for limiting duty-of-care liability and statutory exoneration provisions).
166. There is little doubt that corporate managers have significant power over the terms of corporate governance. For example, business interests were recently able to stop the SEC's efforts to achieve incremental reform of the proxy system. Amy Borrus & Mike McNamee, *A Legacy that May Not Last*, BUS. WK., June 13, 2005, at 38 (discussing business lobbying efforts to derail proxy reform).
167. Bradley & Schipani, *supra* note 17.
168. Steinberg, *supra* note 8, at 919-20.
169. *Id.* at 920.

putatively govern the legal framework in this crucial arena. Dean Joel Seligman noted that the "pendulum quite recently has swung quite far and quite suddenly in a regulatory direction" with the enactment of the Sarbanes-Oxley Act, but this was prompted by a swing of "the pendulum far too aggressively in a deregulatory direction."[170] Professor Roberta Romano stated "that legislating in the immediate aftermath of a public scandal or crisis is" apt to produce "poor public policymaking" that is dominated by "better-positioned . . . policy entrepreneurs" instead of "careful and balanced consideration of the issues."[171] In short, the law of corporate governance is controlled by Chaos.[172] *Smith* shows how seemingly insignificant facts, like the joint defense strategy, may have a durable and deep impact on the law of corporate governance,[173] meaning that sensitivity to initial conditions is satisfied.[174] Like other Chaotic systems, corporate governance exhibits macro-predictability with micro-unpredictability because special interest influence seems to result in predictable overreaching, which in turn leads to crisis and overreaction in very unpredictable ways.[175]

Commentators have recognized the potential role of Chaos Theory in the law, but few have considered controlling Chaos within the law or identifying legal paradigms that may need to be restructured to ameliorate Chaos.[176] It is not that corporate governance lacks order; on the contrary, there is a powerful pattern of laxity followed by crisis, followed by political pressure for federal intervention.[177] The system defies prediction, and relatively minor changes lead to radical and ill-founded outcomes.[178] The system seems to lack any central nervous system, which means that coherence and law tethered to sound policy is compromised. Perhaps the law should strive to reduce Chaos within the corporate governance system. It is time for scholars to focus on improving the institutional structure underlying corporate governance

170. Seligman, *supra* note 98, at 116 n.99.

171. Romano, *supra* note 123, at 1602.

172. *See* Robert E. Scott, *Chaos Theory and the Justice Paradox*, 35 WM. & MARY L. REV. 329, 331 (1993).

> Chaos Theory concerns the phenomenon of "orderly disorder created by simple processes." It is the notion that the laws of the physical world cannot predict what is going to happen in the future. This is not because the laws are invalid, but because even when we understand interactions . . . results in specific cases still can be impossible to predict—even though recurring patterns are discernible and remarkably durable. In sum, there is chaos in order, and there is order in chaos.

Id.

173. *See supra* note 7.

174. *See supra* text accompanying note 23.

175. *See supra* text accompanying note 25.

176. Scott, *supra* note 172, at 348-51 (applying Chaos Theory to longstanding problems of jurisprudence); *see also* Edward S. Adams, Gordon B. Brumwell & James A. Glazier, *At the End of* Palsgraf*, There Is Chaos: An Assessment of Proximate Cause in Light of Chaos Theory*, 59 U. PITT. L. REV. 507, 508 (1998) (applying Chaos Theory to argue in favor of a new approach to proximate cause).

177. *See supra* note 10; *supra* text accompanying notes 170-71.

178. *See supra* text accompanying notes 168-69.

law, rather than the precise substance of corporate law. Simply put, the issue may be how to construct a system of corporate governance tethered to policy and science rather than swinging like a wild pendulum.[179]

IV. Conclusion

Smith led to the death of the duty of care for directors of public corporations in the United States. Nothing in *Smith* justifies this "drastic" change in American corporate law. On the contrary, once *Smith* is viewed in accordance with the narrative proffered in this article, it fails to explain the death of the duty of care, since the case did not change the law or the risks facing directors. This suggests that the death of the duty of care following in the wake of *Smith* was not the product of a highly interventionist court, which required legislative constraint, as many commentators suggest. Moreover, the destruction of the duty of care within the vast majority of public companies is a radical development. Combined with increased laxity in constraints on management of public corporations with respect to other issues of corporate governance, such as the PSLRA, *Smith*'s legacy left us with a most radical outcome—the onset of CEO primacy in the American public corporation.

This article suggests that the onset of CEO-primacy was caused by special interest influence and the exploitation of corporate federalism. Special interests, namely corporate managers and the insurance industry, were able to exploit *Smith* to achieve results that were putatively in their interest. The PSLRA was also the product of special interest influence. CEO-primacy is manifest in empirical data showing that CEOs—not shareholders—select board directors, and in empirical studies showing that the share of profits going to senior executive compensation has doubled since *Smith*. Excessive laxity in legal constraints has now resulted in excessive CEO power. It also resulted in political reaction—the Sarbanes-Oxley Act of 2002.

Unfortunately, the end result of political overreaction may not be beneficial. The Sarbanes-Oxley Act greatly increased the cost of accessing the public capital markets upon all issuers without improving the quality of corporate governance. The system has shifted from wild indulgence to wild over-regulation. This fact suggests that the under-

179. I have made two proposals, each of which could reduce Chaos within the system of corporate governance for public firms. One proposal is to give a depoliticized agency broad authority to articulate best corporate governance standards in accordance with economic science, much as the Federal Reserve Board has power over monetary policy. Steven A. Ramirez, The End of Corporate Governance Law: Optimizing Legal Structures to Secure a Race to the Top (Dec. 15, 2005) (working paper, on file with author). Another proposal is to require that senior executives and board members be professionals, subject to a professional self-regulatory agency, akin to the securities brokerage industry. Ramirez, *supra* note 9.

lying legal structure of our corporate governance system results in standards and laws that are difficult to predict and are untethered to any policy analysis. The system seems best explained by Chaos Theory. Macro-predictability accompanies micro-unpredictability, and the system seems very sensitive to small changes in conditions. Corporate governance scholars should refocus their energy from the content of specific rules or standards to the creation of a legal structure, which could reduce Chaos and place corporate governance on a more stable and scientific foundation.