INDETERMINACY AND SELF-ENFORCEMENT: A DEFENSE OF DELAWARE'S APPROACH TO DIRECTOR INDEPENDENCE IN DERIVATIVE LITIGATION

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INTRODUCTION

In April 2005, Laura Unger, a director on the board of Computer Associates, voluntarily withdrew herself from the special litigation committee her company had formed to investigate allegations of accounting fraud by other members of the board.[1] She did so after shareholders questioned her independence, noting her ties to one of the board members under investigation, former U.S. Senator Alfonse D'Amoto.[2] In the 1990's, Unger had served as counsel to the former senator and in a published interview acknowledged D'Amoto was "instrumental" in recruiting her to the Computer Associates board.[3] Although she defended her "independence-in-fact," she acknowledged her "independence in appearance" was not so clear.[4] "[S]he did not want the litigation committee to finish its work, only to have [that work] questioned by a judge" because of her apparent lack of independence.[5]

Like the majority of the publicly-traded corporations in the United States and 60% of the Fortune 500, [6] Computer Associates is a Delaware corporation,[7] subject to Delaware corporation law. Yet no Delaware court ordered Unger to step down. Moreover, it is far from clear whether Unger would have been considered to lack independence under Delaware law. Instead, she stepped down voluntarily. Why?

Herein, I argue because Delaware law has worked exactly as it was designed: promoting self-enforcement. More specifically, I argue that the indeterminacy of Delaware law forces corporate boards and their lawyers to more closely scrutinize their actions to avoid not only judicial intervention, but also the *risk* of judicial intervention.

In making this argument, I focus specifically on the question of director independence in the context of derivative litigation. Rather than applying a bright-line rule, Delaware courts apply an indeterminate, fact-intensive legal standard to assess director independence. This indeterminate standard has led Delaware courts to seemingly unpredictable and perhaps even contradictory conclusions. Yet, this indeterminacy also promotes the development of self-enforced norms. Because legal indeterminacy raises the risks of litigation and judicial intervention *in theory*, it gives boards and their lawyers a powerful incentive to closely scrutinize and self-police director independence to avoid these risks *in fact*. Thus, rather than the courts policing boards, indeterminacy encourages boards to police themselves. Although no court or law explicitly required Unger to withdraw, no court or law ever had to. Instead, Unger withdrew herself *ex ante* to avoid the risk that a judge would question the committee's findings *ex post*.[8]

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[1] Mark Harrington, *Computer Associates Director Withdraws from Committee*, NEWSDAY, Apr. 12, 2005, at A44.
[2] *Id.*
[3] *Id.*
[4] *Id.*
[5] *Id.*
[6] DIVISION OF CORPORATIONS, State of Delaware, Dep't of State, *available at* http://www.state.de.us/corp/default.shtml (last visited Mar. 30, 2006).
[7] *See* Computer Associates Int'l Inc., Annual Report (Form 10-K) (2005) (available on EDGAR).
[8] Harrington, *supra* note 1.

I make this argument in the context of two recent cases, *In re Oracle Corporation Derivative Litigation*[9] and *Beam ex. rel. Martha Stewart Living Omnimedia v. Stewart*.[10] In both cases, Delaware courts acknowledged that professional, social, and institutional relationships between directors can taint independence. Yet, in applying Delaware's indeterminate legal standard to the relationships at issue in each case, the two courts came out with opposite conclusions on the question of independence. These cases, decided only months apart, illustrate the indeterminacy of Delaware law when considering the effects of professional, social, and institutional relationships on director independence. And if I am right, this indeterminacy, in turn, gives future boards and their lawyers a powerful incentive to avoid even potentially suspect professional, social, and institutional relationships. The result is the development of self-enforced, self-policed norms. And hence, Unger withdrew herself from the special litigation committee before a court was forced to invalidate its findings.

This article proceeds in four sections. Sections I and II respectively introduce the lay legal reader to the role of independent directors in derivative litigation and the analytic framework with which Delaware courts assess independence. With this background, Section III demonstrates the indeterminacy of Delaware law with respect to the effects of professional, social, and institutional ties on director independence. Finally, Section IV defends indeterminacy in the specific context of director independence on two grounds. First, an indeterminate legal standard is the only desirable or possible way to address the intractable concept of independence. Second, indeterminacy, by increasing the risks of litigation and judicial intervention, encourages boards to self-police—to avoid questionable relationships in the first place.

I. DIRECTOR INDEPENDENCE IN DERIVATIVE LITIGATION

Along with shareholder voting, the derivative suit is one of the two principal pillars of corporate governance under state law. The derivative suit enables shareholders to bring suit against their board of directors to enforce the board's fiduciary duties to the corporation. Under Delaware law, any shareholder may bring a suit against a corporate director for a breach of any fiduciary duty that director owes the corporation and its shareholders.[11] The suit is considered a derivative suit because the claim belongs to the corporation, not the shareholders. Even though the suit is brought by a shareholder, the legal rights being asserted belong to the corporation.

The shareholders' ability to bring a derivative suit, however, is limited by the procedural requirements of demand and the review of a special litigation committee (SLC). The extent to which either demand or the SLC procedure presents a hurdle to the shareholders' ability to pursue a derivative suit depends largely on the disinterestedness and independence of the directors on the board. This section examines demand and the SLC procedure in turn, focusing particularly on the role of disinterested and independent directors in each step.

[9] 824 A.2d 917 (Del. Ch. 2003).

[10] 845 A.2d 1040 (Del. 2004).

[11] Shareholder standing to bring a derivative suit is actually subject to a few technical requirements that are immaterial to the discussion here. *See* Del. Ch. R. 23.1.

A. Pre-suit Demand and Demand Excused

Before a disgruntled shareholder can file a derivative suit against a director, she must first make pre-suit demand upon the board to bring the suit itself.[12] The *legal* justification for the demand requirement stems from a principal tenant of the Delaware corporation statute, which vests the board, and not shareholders, with the authority to manage the business affairs of the corporation.[13] Because a derivative suit asserts a claim belonging to the corporation, the decision whether to assert that claim, like all other business decisions, belongs to the board of directors.[14] The *policy* justification for the demand requirement is twofold. First, the requirement of demand promotes a type of alternative dispute resolution by forcing disgruntled shareholders to seek and exhaust intra-corporate remedies before pursuing costly litigation.[15] Second, and more importantly, demand serves as a screening mechanism for costly "strike suits," baseless claims brought for the purpose of extortion or forcing a windfall settlement.[16]

If a shareholder does make demand, the board, of course, may refuse to proceed with the suit. For the shareholder, the danger in this is that, like any other board decision, Delaware courts apply the highly deferential "business judgment rule" to the board's decision to refuse demand.[17] So long as the board made its decision impartially and in good faith, the court will not review the board's decision to refuse demand.[18] The suit is over before it begins.

To avoid this prospect, the shareholder must successfully argue that demand should be excused. Shareholders are excused from making demand if they can establish that demand upon the board would be futile. To establish futility, the shareholder must allege particularized facts that create reasonable doubts as to a majority of the board's disinterestedness or independence.[19]

This heightened pleading standard for alleging demand futility, requiring allegations of particularized facts, prevents a shareholder from evading demand by simply naming every member of the board as a defendant.[20] Conclusory allegations that a board member is interested or lacks independence, without particularized facts raising reasonable doubts about an individual member's ability to objectively and impartially consider demand, do not make demand futile.[21] At the same time, if the shareholder can plead, with particularity, facts that raise reasonable doubts about a majority of the board's ability to

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[12] *Id.*.
[13] DEL. CODE ANN. tit. 8 § 141(a) (2005).
[14] *See* Aronson v. Lewis, 473 A.2d 805, 811-12 (Del. 1984).
[15] *See* Grimes v. Donald, 673 A.2d 1207, 1216 (Del. 1994).
[16] *See id.* at 1217.
[17] *Aronson*, 473 A.2d at 811-13.
[18] *Id.* at 812.
[19] *Id.* at 814. "Reasonable doubts" has been subsequently clarified to mean "reasons to doubt." *Grimes*, 673 A.2d at 1217.
[20] *See Aronson*, 473 A.2d at 815.
[21] *Martha Stewart*, 845 A.2d 1040, 1050 (Del. 2004).

disinterestedly or independently consider pursuing a lawsuit against one of their own, the shareholder is excused from making demand.[22]

B. Special Litigation Committee

Even if the shareholder can establish that demand should be excused because a majority of the board lacks disinterestedness or independence, the board has a second chance to terminate the derivative suit. The board may establish a committee of disinterested and independent directors to investigate the merits of the shareholder's allegations and determine whether it would be in the best interest of the corporation to proceed with the suit.[23]

This "special litigation committee" (SLC) procedure was first recognized in Delaware law in *Zapata Corp. v. Maldonado*.[24] The *legal* justification is again the Delaware corporation statute, which permits the board to delegate all of its authority, including the authority to terminate a lawsuit, to a subcommittee of directors.[25] Even if a majority of the board is too tainted to consider demand, that taint does not bar the board from delegating its authority to an SLC comprised of disinterested and independent directors, to determine whether the proposed suit should be terminated.[26] The *policy* justification for the SLC procedure, like the demand requirement, is again to provide another screening mechanism to prevent costly strike suits.[27]

In reviewing an SLC's recommendation, Delaware courts consider, among other things,[28] the disinterestedness and independence of the SLC directors.[29] Thus, like the board's ability to consider pre-suit demand, the SLC's ability to terminate a derivative suit turns upon the disinterestedness and independence of its members.

II. DIRECTOR INDEPENDENCE: THE ANALYTIC FRAMEWORK

In both the contexts of considering demand futility and the recommendations of an SLC, Delaware courts examine the disinterestedness and independence of the directors. Like so much of Delaware's corporate law, disinterestedness and independence are judicially defined concepts. This section will explore these analytically distinct yet related concepts. Part A distinguishes and compares the two. Part B elaborates on the relationships that affect director independence.

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[22] *See id.*
[23] *See* Zapata Corp. v. Maldonado, 430 A.2d 779, 786 (Del. 1981). This is precisely the type of committee Unger withdrew from. *See supra* notes 1-5 and accompanying text.
[24] 430 A.2d 779 (Del. 1981).
[25] DEL. CODE ANN. tit. 8 § 141(c)(1) (2005).
[26] Zapata, 430 A.2d at 786.
[27] *Id*. at 786-87.
[28] In the SLC context, the court will also look to see if the SLC members acted in good faith and whether their recommendations are reasonable. *See Zapata*, 430 A.2d at 788-89. These additional inquiries, however, are irrelevant for the purposes of this paper.
[29] *Id.* at 786, 789-90.

A. Director Disinterestedness and Independence

1. Director Disinterestedness

A director is interested if she received a *direct personal financial benefit* from the now-challenged action that was not equally shared by all shareholders.[30] In such cases, the interested director cannot be expected to impartially and objectively consider the proposed suit without being influenced by the personal consequences that may result from her decision.[31]

Defined thusly, the distinction between disinterested and interested directors is relatively clear. The index of interest, a direct personal financial benefit, is an observable fact. Only those directors who receive a direct personal financial benefit from the now-challenged action are interested. As a result courts,[32] and indeed litigants,[33] have had relatively little trouble sorting out interested directors in derivative litigation.

2. Director Independence

A director lacks independence when she is unable to *objectively* and *impartially consider* the corporate merits of the proposed suit without being influenced by extraneous considerations.[34] In assessing a director's objectivity and impartiality, courts examine her relationship with an interested director to see whether that relationship may bias her independent decision-making. In the language of Delaware law, a director lacks the independence if she is "beholden to"[35] or "dominat[ed] and control[led]"[36] by an interested director. Even though a director did not personally benefit from the now-challenged action, her *relationship* with an interested director—a director who did personally benefit from the now-challenged action—may make her unable to objectively and impartially assess the proposed suit. Put differently, although she may be disinterested, a director may nonetheless lack independence.

Unlike disinterestedness, director independence has proven much more difficult to apply in practice. Recall that disinterestedness turns on an observable fact: whether the director received a direct personal financial benefit from the now-challenged action. Independence, however, turns on an unobservable state of mind: the director's ability to *objectively* and *impartially consider* a proposed suit based solely on the corporate merits, without *influence* resulting from her relationship with an interested director.[37] Because independence turns on an intangible and unobservable state of mind, courts and litigants

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[30] *Martha Stewart,* 845 A.2d at 1049 (citing Rales v. Blasband, 634 A.2d 927, 936 (Del. 1993)).
[31] *Martha Stewart*, 845 A.2d at 1049.
[32] *See, e.g.*, Steiner v. Meyerson*,* 1995 WL 441999, at *9 (Del. Ch. 1995) (finding director is "unquestionably interested").
[33] *See, e.g.*, Harbor Fin. Partners v. Huizenga, 751 A.2d. 879, 886 (Del. Ch. 1999) (board conceding the interest of three directors with respect to the challenged transaction).
[34] "Independence means that a director's decision is based on the corporate merits [of the proposed suit] . . . rather than extraneous considerations or influences." *Aronson*, 473 A.2d at 816. *See also Martha Stewart*, 845 A.2d at 1050 (citing *Aronson*); In re Oracle Corp. Derivative. Litig., 824 A.2d 917, 938 (Del. Ch. 2003) (summarizing Delaware Supreme Court's inquiry into independence as "ultimately focus[ing] on impartiality and objectivity") (citing Parfi Holding AB v. Mirror Image Internet, Inc., 794 A.2d 1211, 1232 (Del. Ch. 2001), *rev'd in part on other grounds*, 817 A.2d 149 (Del. 2002).
[35] *Martha Stewart*, 845 A.2d at 1050; *Oracle*, 824 A.2d at 938-39.
[36] *Aronson*, 473 A.2d at 815.
[37] *See supra* note 34.

have had significantly more difficulty in evaluating whether a director is truly independent from an interested director. Human psychology is unobservable; judicial inquiry into mental states is necessarily speculative. A judge cannot peer into a director's mind to determine whether she is objective and impartial, free of extraneous influences.

Instead, judges have looked to the *relationships* that exist between directors—the source of the potentially extraneous influence on a director's impartiality and objectivity—to assess director independence. Focusing on a relationship rather than a director's mental state, however, has only shifted the problem of assessing independence into a new context. A myriad of relationships can influence independence.

B. Relationships bearing on Independence

Consider the typical case: A corporation's chairman of the board, who also serves as its CEO, is the target of a shareholder suit alleging a breach of the duty of loyalty. In the case of self-dealing, the chairman/CEO is by hypothesis interested in the now-challenged transaction. But consider how the chairman's relationships with other board members could compromise *those board members' independence—their* ability to impartially and objectively consider the proposed suit against the chairman based solely on the corporate merits.

Most obviously, any *economic* relationship between the chairman/CEO and a director could compromise that director's independence. Inside directors—directors who also work as employees of the corporation—typically earn large salaries as executives of the corporation. Approving a lawsuit against the boss, the CEO, could well risk an inside director his job and its accompanying salary. Even nominally outside directors—directors who have full-time positions outside of the corporation—may have lucrative business dealings with the chairman or the corporation.[38] In such a circumstance, a director may feel that approving a suit against the chairman would jeopardize the future of his lucrative business dealings with the chairman or the corporation.

Likewise, a *familial* relationship between the chairman and a director could compromise that director's independence. Family members commonly sit as directors on the same board.[39] Given "the deep bonds that most people have to members of their families," it is difficult to imagine any director could "set aside instinctive feelings of love and loyalty and . . . deal objectively with the merits" of a proposed suit against a member of his own family.[40]

Beyond the easily observable economic and familial ties, however, the chairman/CEO may also have numerous *professional* and *social* ties to the other directors on the board.

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[38] *See* LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION 27 (2004). Professors Bebchuk and Fried discuss how the many ties between company executives and nominally independent directors compromise the arm-length bargaining between the two parties in the context of negotiating executive compensation contracts. Yet much of their analysis is applicable here in the context of directors deciding whether to pursue a lawsuit against a company executive.

[39] *See, e.g.*, Rales v. Blasband, 634 A.2d 927 (Del. 1993) (involving two brothers sitting as directors on the same board); Mizel v. Connelly, 1999 WL 550369 (Del. Ch. July 22, 1999) (involving grandfather and grandson on the same board).

[40] Mizel v. Connelly, 1999 WL 550369, *4 n. 4.

The world of corporate directors is small.[41] Many directors serve on multiple boards and on multiple boards with the same directors.[42] These "interlocking" directorates create and foster strong social networks.[43] Directors are often friends.[44] They run in the same social crowds. Their children attend the same schools. They attend the same operas. In such circumstances, a director may be hesitant to approve a suit against the chairman, fearing that doing so will complicate his relationship with the chairman both within the boardroom as well as in other professional and social contexts.[45]

These social and professional ties are only exacerbated when one considers the influence the chairman/CEO has over nominating and electing individuals to the board.[46] A director may feel he owes his seat on the board to the chairman, who personally nominated him.[47] As a result of his indebtedness, the director may feel a sense of obligation or loyalty to the chairman.[48]

And even if a director did not know the chairman before serving on the board, once in the boardroom strong personal and collegial bonds can form.[49] Given their common social background and professional experience, directors often share a common frame of reference—similar worldviews and professional sensibilities—at the outset.[50] And over time, professional and social norms within the boardroom tend to foster group cohesion, politeness, and an avoidance of conflict and confrontation.[51] As one experienced director put it, "It is hard to explain to a person who is not a director. It is in many ways a club."[52]

Finally, in addition to the professional and social bonds, the chairman may also have strong *institutional* ties to other board members that could bias those board members' independence. Corporations expend billions of dollars in charitable contributions, and CEOs often direct these contributions to their directors' favorite causes.[53] A director may be the president of an educational or charitable institution to which the chairman/CEO has contributed, either personally or through the corporation. He may feel indebted to the chairmen for past contributions. Or he may feel the need to please the chairman to successfully solicit future contributions.

Such professional, social, and institutional relationships among directors are not uncommon. And, although such ties are not as obvious or easily detected as economic or familial ties, they can nonetheless have powerful psychological influences on a director's independent decisionmaking.

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[41] *See* Gerald F. Davis et al., *The Small World of the American Corporate Elite, 1982-2001*, 1 STRATEGIC ORGANIZATION 301 (2003), *reprinted in* CORPORATE GOVERNANCE: LAW, THEORY, AND POLICY 356, 356 (Thomas. W. Joo, ed., 2004).

[42] *See* BEBCHUK & FRIED, *supra* note 38, at 30; Davis et al., *supra* note 41, at 356. The extent of interlocking directorates is starkly illustrated by http://www.theyrule.net, an interactive website where users can map out chains of directors who serve on multiple corporate boards.

[43] *See generally* Davis et al., *supra* note 41.

[44] BEBCHUK & FRIED, *supra* note 38, at 31.

[45] *Id.* at 31-32.

[46] *See id.* at 25-26.

[47] *See id.* at 26.

[48] *See id.* at 31.

[49] *See id.* at 31-32.

[50] Davis et al., *supra* note 41, at 358.

[51] BEBCHUK & FRIED, *supra* note 38, at 32.

[52] *Id.*

[53] *Id.* at 28.

Thus, the difficulty of focusing on the relationships between directors is that *all* relationships *could* influence a director's ability to objectively and impartially consider a proposed suit. As a result, focusing on the relationship rather than a director's subjective objectivity and impartiality has not been particularly helpful in simplifying the independence inquiry. Independence remains a vacuous, intractable concept that ultimately depends on an unknowable state of mind. And so, it is perhaps unsurprising that Delaware courts' attempts to define independence have led to doctrinal indeterminacy.

III. THE INDETERMINACY OF DELAWARE'S DIRECTOR INDEPENDENCE JURISPRUDENCE

In legal analysis, indeterminacy refers to a legal standard that, when applied to like fact patterns, can or does yield different legal results. To understand how this may be, one must understand the difference between *standards* and bright-line *rules*. In applying a bright-line *rule*, a judge need only determine whether certain pre-set conditions are met.[54] If so, a determinative legal outcome must result. In contrast, a *standard* "lay[s] out general principles to be applied by judges to particular sets of facts."[55] Unlike bright line rules, judges enjoy broad discretion in applying legal standards to specific fact patterns.

Standards can thus give rise to indeterminacy. Because standards set out general principles, "[t]heir meaning is revealed only when they are applied by [a] court to specific scenarios."[56] Further, because different judges will consider different facts material to the resolution of a dispute, two judges applying the same legal standard to the same set of facts may come out with different legal resolutions. Moreover, because no two fact patterns are *ever* identical, a judge is never bound by prior precedent. Instead, subsequent judges, applying the same legal standard to a similar fact patterns, are always able to distinguish prior precedents on specific factual grounds.

Delaware law on director independence in derivative litigation is one such indeterminate legal standard. This indeterminacy is a result of Delaware courts' ambiguous and even inconsistent treatment of non-economic, non-familial, professional, social, and institutional relationships and their effects on director independence. Although the law is comparatively clear regarding the effects of material economic and familial ties on director independence, it has always been ambiguous in its treatment of professional, social, and institutional relationships and their effects on director independence. Whether these suspect ties affect director independence seems to depend entirely on the specific facts of a given case. This was true before the recent *Oracle* and *Martha Stewart* decisions and remains true today.

This section proceeds in three parts. Part A demonstrates the indeterminacy of Delaware law with respect to professional, social, and institutional ties before the *Oracle* and *Martha Stewart* decisions. Part B then analyzes these decisions. Finally, Part C argues that Delaware law remains ambiguous in its treatment of professional, social, and institutional ties and their effects on director independence even after *Oracle* and *Martha Stewart*. And, as a result of applying this ambiguous law, indeterminacy will abound.

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[54] Ehud Kamar, *A Regulatory Competition Theory of Indeterminacy in Corporate Law,* 98 COLUM. L. REV. 1908, 1914 (1998).
[55] *Id*.
[56] *Id*. at 1915.

A. Indeterminacy before *Oracle* and *Martha Stewart*

Over time, Delaware courts have been fairly consistent in their treatment of material economic and familial relationships and their effect on director independence: a director with a material economic or familial relationship with an interested director lacks independence. When considering *non*-economic, *non*-familial ties, however, Delaware law has not been as clear. Even before *Oracle* and *Martha Stewart*, Delaware cases were inconsistent in their treatment of professional, social and institutional relationships and their effect on director independence.

1. Material Economic and Familial Relationships

Delaware law has given corporate boards and corporate lawyers clear guidance with respect to material economic and familial relationships: such relationships compromise a director's independence.[57] Delaware courts have frequently held that a director lacks independence if he has or has had some material economic or financial tie to an interested director. In most cases, the director lacks independence because he is also a high-level executive within the corporation, and approving a lawsuit against an interested director could jeopardize his position and executive salary.[58] But even nominally outside directors have also been held to lack independence when they are found to have material outside financial dealing with the corporation or the interested director.[59] Although there is certainly ambiguity in what constitutes materiality,[60] the law is clear in that a director who has a material economic relationship with an interested director lacks independence.

Likewise, Delaware courts have generally held that a familial relationship with an interested director can compromise a director's independence.[61] As Vice-Chancellor Strine has noted, "[t]he existence of a very close family relationship between directors should, without more, generally go a long (if not the whole) way toward creating a reasonable doubt [as to independence]."[62] Although there is certainly ambiguity with

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[57] *See* BNA CORPORATE PRACTICE SERIES, No. 79 § II (2005).

[58] *See, e.g.*, Rales v. Blasband, 634 A.2d 927, 937 (Del. 1993) (inside director who also serves as corporation's president and CEO lacks independence to consider demand); *id*. (director who serves as president of subsidiary company in which interested directors are also directors and majority shareholders lack independence to consider demand); In re The Limited, Inc. S'holder Litig, 2002 WL 537692, *5 (Del. Ch. Mar. 27, 2002) (director who also serves as corporation's chief administrative officer lacks independence to consider demand against chairman and CEO); *id*. (director who serves as executive of a corporation's wholly owned subsidiary lacks independence for purposes of demand); Steiner v. Meyerson, 1995 WL 441999, *9-10 (Del. Ch. July 19, 1995) (director who also serves as corporation's COO and CFO lacks independence for purposes of considering demand).

[59] *See, e.g.*, In re Walt Disney Co. Derivative Litig., 731 A.2d 342, 358-59 (Del. Ch. 1998) (architect frequently commissioned both by the corporation and the CEO lacks independence to consider demand); *Steiner,* 1995 WL 441999, at *10 (director whose law firm provides legal services to corporation lacks independence for purposes of considering demand); *The Limited*, 2002 WL 537692, at *6 (director who also provides consulting services to the corporation and is paid separately for those services lacks independence to consider demand).

[60] *Compare Walt Disney*, 731 A.2d at 358 (director who earned millions of dollars over several years for architectural services provided to corporation lacks independence to consider demand) *with The Limited*, 2002 WL 537692, at *5 (director who earned $400,000 in revenue annually for services provided to the corporation does not lack independence to consider demand).

[61] *See, e.g.*, *Mizel*, 1999 WL 550369, at *4.

[62] *Id*.

respect to distant familial relationships,[63] the law is clear in that a director is not independent of an interested director who is also a close family member.

2. Professional, Social, and Institutional Relationships

When considering a director's non-economic, non-familial professional, social, and institutional relationships with an interested director, Delaware law has been ambiguous and indeterminate. While the case law has not totally dismissed the subtle influences such relationships can have, it has given directors and their lawyers no clear guidance on the specific types of relationships that may jeopardize a director's independence.

With respect to the *professional* and *social* relationships between directors, Delaware courts have often held that a director's personal friendship with an interested director, alone, does not compromise that director's independence.[64] Likewise, the courts have frequently held that a director does not lack independence simply because she owes her director's seat to an interested director,[65] even when her salary as director comprises a substantial portion of her overall income.[66] Despite the personal loyalties and feelings of indebtedness a director may feel toward an interested director, such influences apparently do not worry Delaware courts.

Yet, at the same time, the Delaware courts have also shown concern about interlocking directorships and their effects on a director's ability to objectively and impartially consider the merits of a proposed suit.[67] Moreover, the Delaware Supreme Court, in the two seminal cases on demand and the SLC procedure, *Zapata* and *Aronson*, explicitly acknowledged the effects personal relationships and the inherent social biases within the boardroom can have on a director's independence. The *Zapata* court noted that directors might be subtly influenced by their personal loyalties and feeling of indebtedness to their fellow directors.

> [W]e must be mindful that directors are passing judgment on fellow directors in the same corporation and fellow directors . . . who designated them to serve . . . as directors. . . . The question naturally arises whether a

[63] *Compare id*. (director lacks independence from grandfather for the purposes of considering demand against him) *with* Seibert v. Harper & Row Publishers, Inc., 1984 WL 21874, at *3 (Del. Ch. Dec. 5, 1984) (director is independent of cousin for the purposes of considering demand against him).

[64] *See, e.g.*, Litt v. Wycoff, 2003 WL 1794724, at *4 (Del. Ch. Mar. 28, 2003) (holding "mere personal friendship" does not raise reasonable doubts as to independence); Green v. Phillips, 1996 WL 342093, at *5 (Del. Ch. June 19, 1996) (holding allegations of "longstanding personal … ties … are insufficient" to compromise independence); In re Paxson Commc'n Corp. Shareholders Litig., 2001 WL 812028, at *10 (Del. Ch. July 12, 2001) (holding generalized allegations of "close personal . . . ties" do not compromise independence).

[65] *See, e.g., Aronson*, 473 A.2d at 815.

[66] *See Walt Disney,* 731 A.2d at 359-60 (holding director does not lack independence despite being nominated to the board by the interested director and despite the fact that her salary as director was substantially higher than her salary from her full-time position as an elementary school principal).

[67] *See* Lewis v. Fuqua, 502 A.2d 962, 966-67 (Del. Ch. 1985) (finding SLC director, a university president, lacks independence from director who serves as trustee on that university's board); Biondi v. Scrushy, 820 A.2d 1148, 1165-66 (Del.Ch. 2003) (finding SLC director lacks independence, at least in part, because he served on two other boards with the interested director); *see also Walt Disney*, 731 A.2d at 359 (stating in dicta that "an interlocking directorship . . . would likely lead to a reasonable doubt [regarding] independence").

> "there but for the grace of God go I" empathy might not play a role [in the director's decision.][68]

Three years later, the *Aronson* court, in holding that majority stock ownership by an interested director alone does not compromise other directors' independence, noted that "[t]here must be coupled with the allegation of control such facts as would demonstrate that through *personal* or other relationships the directors are beholden to the controlling person."[69] Both decisions seem to reflect the notion that non-economic, non-familial professional and social relationships can affect a director's independent decision-making.

With respect to *institutional* ties between directors, Delaware law has been equally indeterminate. In a series of cases, the Delaware courts have considered whether a director who also heads a non-profit educational institution lacks independence from a director who has personally, or in his official capacity, donated money to that institution. In each case, the determination of independence turned on a highly fact-specific analysis. In *Fuqua*, the president of Duke University was held to lack independence from an interested director who had made several contributions to the university, recently pledged another $10 million donation, and also served as a trustee on the university board.[70] But in *Disney*, the president of Georgetown University was held to be independent from the company CEO who had recently donated over $1 million dollars to the university.[71] Chancellor Chandler distinguished *Disney* from *Fuqua* on the grounds that the interested director in *Fuqua* also had (i) prior political and financial dealings with Duke's president and (ii) served as trustee on the university's board.[72] For Chancellor Chandler, these facts justified the different outcomes. Then in *The Limited*, the former president of Ohio State University was held to lack independence from an interested director who had donated $25 million to the university during the former president's tenure.[73] Vice-Chancellor Noble considered both *Fuqua* and *Disney*, and reasoned that even though the directors did not have past political and financial dealings and did not serve other boards together like the directors in *Fuqua*, the former president's sense of indebtedness to the interested director for the generous donation was enough to compromise his independence.[74] In short, the two facts which the *Disney* court isolated to distinguish *Fuqua*, the *The Limited* court set aside as unimportant to its determination. Like professional and social relationships, Delaware law has employed an indeterminate, fact-intensive analysis to assess the effects of institutional relationships on independence.

B. *Oracle* and *Martha Stewart*

Part A demonstrated that up until June 2003, Delaware law was ambivalent about the effects of non-economic, non-familial, professional, social, and institutional ties on director independence. *Oracle* and *Martha Stewart*, decided only ten months apart, squarely deal with this issue. Yet, the two cases ultimately come out on opposite sides of

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[68] *Zapata*, 430 A.2d at 787.
[69] *Aronson*, 473 A.2d at 815 (emphasis added).
[70] *Fuqua*, 502 A.2d at 966-67.
[71] *Walt Disney*, 731 A.2d at 358-59.
[72] *Id*. at 359.
[73] *The Limited*, 2002 WL 537692, at *5-6.
[74] *Id*.

the independence inquiry. Together, *Oracle* and *Martha Stewart* do little to resolve the indeterminacy of Delaware law regarding the effects of non-economic, non-familial professional, social, and institutional relationships on director independence.

1. In re Oracle Corporation Derivative Litigation

Oracle was decided on a motion to terminate brought by an SLC formed to investigate shareholder claims alleging insider trading against four of the Oracle Corporation's directors.[75] The SLC consisted of two directors, Grundfest and Garcia-Molina, both of whom are tenured professors at Stanford University and both of whom were appointed to the board ad hoc for the special purpose of investigating the shareholder claims.[76] The professors performed exhaustive investigation and produced a 1,110 page report to support their motion.[77]

Upon filing the motion to terminate, the plaintiffs were granted limited discovery into, among other things, the SLC directors' independence from the four defendant directors.[78] Discovery unearthed extensive institutional ties between the two SLC directors and four defendant directors, all involving Stanford University, and most of which were not revealed in the SLC's 1,110 page report.[79] Like Grundfest and Garcia-Molina, one defendant director was also a professor at Stanford.[80] In fact, "he had taught Grundfest when Grundfest was a Ph.D. candidate" at Stanford.[81] As professors, both he and Grundfest now serve as senior fellows at a university-run economic research and policy institute.[82] Another director, an alumnus of Stanford, had donated to the university \$4.1 million personally and \$11.7 million in his capacity as the chairman of a charitable foundation.[83] A third director, as the head of another charitable foundation, had donated \$10 million to Stanford.[84] Moreover, this director had privately discussed with Grundfest and publicly announced his desire to donate hundreds of millions of dollars more to the university.[85]

Notwithstanding these extensive institutional ties, the SLC directors argued that they were independent of the defendant directors. The interested defendant directors, they argued, could not deprive them of either their positions as tenured professors or their ability to make a nice living.[86] In a thoughtful and eloquent opinion, however, Vice-Chancellor Strine rejected the SLC recommendations, holding that the professors were unable to show their independence from the defendant directors.[87]

The *Oracle* opinion is most remarkable, however, not for its holding on the facts, but for Vice-Chancellor Strine's broader discussion of professional, social, and institutional relationships and their possible effects on independence. He decried

[75] *Oracle*, 824 A.2d at 921.
[76] *Id*. at 923.
[77] *Id*. at 925.
[78] *Id*. at 928.
[79] *Id*. at 930-31.
[80] *Id*.
[81] *Id*.
[82] *Id*.
[83] *Id*. at 931-32.
[84] *Id*. at 932.
[85] *Id*. at 934-36.
[86] *Id*. at 936.
[87] *Id*. at 942.

Delaware courts' myopic focus on the most obvious sources of human motivation—money and family—to the exclusion of other potent influences on human behavior. With respect to professional and social relationships, Strine reasoned

> Delaware law should not be based on a reductionist view of human nature that simplifies human motivations on the lines of the least sophisticated notions of the law and economics movement. *Homo sapiens* is not merely *homo economicus*. . . .[A]n array of other motivations exist that influence human behavior; . . . motives like love, friendship, and collegiality.[88]

And adding institutional ties to his analysis, Strine stressed

> [Delaware law] should [not] ignore the social nature of humans....[C]orporate directors are generally the sort of people deeply enmeshed in social institutions. Such institutions have norms, expectations that, explicitly and implicitly, influence and channel the behavior of those who participate in their operation.... [O]ur law . . . cannot assume . . . that corporate directors are as a general matter, persons of unusual social bravery, who operate heedless to the inhibitions that social norms generate for ordinary folk.[89]

Thus, *Oracle*'s dicta seemed to signal an end to the relative ambiguity in Delaware law in its treatment of professional, social, and institutional relationships and their effects on director independence. Such relationships were to be on equal footing with economic and familial relationships in their ability to influence a director's independent judgment. Henceforth, independence was to be a "contextual" inquiry[90] that "necessarily draw[s] on a general sense of human nature."[91] Just as economic and familial ties can impair a director's objectivity and impartiality, so too can other professional, social, and institutional ties.

2. Beam ex rel. Martha Stewart Living Omnimedia, Inc.

Ten months later, in *Martha Stewart*, the Delaware Supreme Court revisited the issue of non-economic, non-familial ties and their effect on director independence. *Martha Stewart* was decided at the demand stage on a motion to dismiss for failure to make pre-suit demand brought by the defendant director, homemaking celebrity Martha Stewart, the CEO of Martha Stewart Omnimedia (MSO) and chairwoman of its board.[92] The plaintiff-shareholder argued demand should be excused because a majority of the board was not independent from Stewart. Because the case was being decided at the demand stage, the plaintiff did not have access to discovery into the directors'

[88] *Id.* at 938.
[89] *Id.*
[90] *Id.* at 939.
[91] *Id.* at 943.
[92] *Martha Stewart,* 845 A.2d at 1044.

independence from Stewart. Instead, the court considered the facts alleged in plaintiff's complaint to assess independence.[93]

The complaint essentially alleged that three of the six directors lacked independence due to their longstanding personal friendships and professional relationships with Stewart. The plaintiff supported these allegations with particularized facts. One director, Martinez, was recruited to the MSO board by a mutual friend of hers and Stewart's.[94] Before she was a director at MSO, Martinez served as a director and executive at Sears, Roebuck and Co., a retailer that sold substantial volumes of MSO's products.[95] A second director, Moore, attended a wedding reception with Stewart hosted by Stewart's personal lawyer.[96] Moreover, a Fortune magazine article highlighted his close personal friendship with Stewart.[97] A final third director also served as a director on the board of a large publishing house and, at the behest of Stewart, had personally contacted the publishing house's CEO to express concern about the publication of an unflattering biography about Stewart.[98]

The Delaware Supreme Court, however, was unimpressed, holding that these allegations, even if proven true, were insufficient to raise reasonable doubt regarding the three directors' independence from Stewart.[99]

> Allegations that Stewart and the other directors moved in the same social circles, attended the same weddings, developed business relationships before joining the board, and described each other as "friends," even when coupled with Stewart's 94% voting power [in MSO], are insufficient, without more, to rebut the presumption of independence.[100]

More importantly, unlike the *Oracle* court, *Martha Stewart* seemed to approach the effects of non-economic, non-familial relationships with the same ambivalence as prior cases. While grudgingly acknowledging that "[a] variety of motivations, including friendship, may influence [a director's decision-making]," the court held that only demonstrably "bias-producing" relationships will compromise a director's independence.[101] To compromise independence, the director's "friendship must be accompanied by substantially more … [to] support the inference that because of the nature of a relationship or [other] additional circumstances …, the non-interested director would be more willing to risk his or her reputation than risk the relationship with the interested director."[102] Thus, while not constricting the scope of the independence inquiry to only economic and familial relationships, *Martha Stewart* recasts doubt on professional, social, and institutional ties as possible sources of influence on director

[93] *Id.* at 1045.
[94] *Id.*
[95] *Id.*
[96] *Id.*
[97] *Id.*
[98] *Id.* at 1046.
[99] *Id.* at 1051.
[100] *Id.*
[101] *Id.* at 1050.
[102] *Id.* at 1052.

independence. In doing so, however, the Supreme Court did not simply ignore *Oracle*. Rather, it explicitly addressed *Oracle*, distinguishing the case on both procedural and factual grounds.

Procedurally, the Court noted that *Oracle* was decided in the SLC context whereas *Martha Stewart* was decided in the pre-suit demand context.[103] With respect to independence, these procedural postures are different in two important ways. First, unlike the pre-suit demand context, where plaintiffs must rebut the directors' presumption of independence, in the SLC context the SLC directors have the burden of establishing their own independence.[104] Moreover, unlike the plaintiffs in the pre-suit demand context, plaintiffs in the SLC context have access to discovery into, among other things, the SLC directors' independence.[105] While the court was mindful to note that it was not suggesting the substantive standard of independence is different in the two procedural contexts, it provocatively added that, "[a]s a practical matter, the[se] procedural distinction[s] … may be *outcome-determinative* on the issue of independence."[106]

Factually, the Court was not as verbose in distinguishing the cases. Instead, it quietly noted that "[a]side from the procedural distinctions, the Stanford connections in *Oracle* are factually distinct from the relationships present here."[107]

C. Indeterminacy after *Oracle* and *Martha Stewart*

Oracle and *Martha Stewart* seem to take very different approaches with respect to the effects of professional, social, and institutional ties on director independence and, as a result, the two cases come out on opposite sides of the independence inquiry. In distinguishing the two cases, some have suggested that the courts' differing approaches can be explained on procedural grounds. Still others have argued the two cases can be distinguished on substantive legal grounds.

I argue that *Martha Stewart* and *Oracle* cannot be satisfactorily distinguished on either procedural or substantive legal grounds. Instead, the two cases' different analyses and results must be based on the specific facts of each case. Thus, the effect of non-economic, non-familial, professional, social, and institutional ties on director independence remains a fact-intensive and therefore indeterminate standard.

1. Procedural Distinctions are Unconvincing

In distinguishing *Martha Stewart* from *Oracle*, the Delaware Supreme Court suggested that procedural differences between the demand and SLC contexts "may be outcome determinative on the issue of independence."[108] Unlike the pre-suit demand context, in the SLC context, (i) the SLC directors have the burden of establishing their own independence and (ii) the plaintiffs have access to discovery into the SLC directors' independence.[109] Notwithstanding the Delaware Supreme Court's dicta, however, it is

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[103] *Id.* at 1054-55.
[104] *Id.* at 1055.
[105] *Id.*
[106] *Id.* (emphasis added).
[107] *Id.*
[108] *Id.*
[109] *Id.*

quite unlikely that these procedural differences are in fact "outcome determinative" on the question of independence.

First, the proposition that the procedural distinctions between the demand and SLC contexts alone are "outcome determinative," if taken seriously, would lead to absurd results. If such procedural differences are truly outcome determinative, each case's underlying facts would by hypothesis be irrelevant to the outcome of the case. Put differently, given any conceivable set of facts, the outcome of the independence inquiry would be determined solely by the procedural context—whether the case was at the pre-suit demand stage or at the SLC stage. It would be inconceivable that the Delaware Supreme Court intended each case's underlying facts to be irrelevant to the independence inquiry.[110]

Second, as a legal matter, the Delaware Supreme Court's suggestion that the procedural differences may be "outcome determinative" on the question of independence,[111] again if taken seriously, would have profound and likely unintended consequences on longstanding Delaware case law. If the *outcome* of the independence inquiry was *determined* by only (i) whether the SLC directors had the burden to show their independence and (ii) whether the plaintiffs had access to discovery, then no SLC would be able to demonstrate its independence.[112] If no SLC could demonstrate its independence, however, *Martha Stewart* would effectively overrule *Zapata*, the seminal case that first recognized the SLC procedure. If the court intended to overrule *Zapata*, it seems unlikely that it would have done so in such casual dicta.

It is unclear what the court meant when it suggested that the procedural differences between the SLC and demand contexts may be "outcome determinative on the issue of independence."[113] Whatever it did mean, it could not have intended what its opinion actually suggested because the results would be absurd and likely unintended. Moreover, there is no language to suggest that the court intended the procedural differences to be outcome determinative *with respect to the effects of professional, social, and institutional relationships on director independence*. In other words, the procedural differences alone cannot explain the two cases' differing approaches regarding the effects of professional, social, and institutional relationships on director independence. *Martha Stewart* and *Oracle* must be distinguished on either substantive legal or factual grounds. As the following section will show, however, it is unlikely the two cases can be distinguished on substantive legal grounds.

2. Substantive Legal Distinctions are Dubious

Although the Delaware Supreme Court expressly declined to decide whether different substantive standards of independence apply in the demand and SLC contexts,[114] some practitioners have interpreted *Martha Stewart* to signal a newfound skepticism in

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[110] Indeed, the Delaware Supreme Court expressly acknowledged that "[I]ndependence is a fact-specific determination." *Id.* at 1049.
[111] *Id.* at 1055.
[112] *See* David H. Kistenbroker et al., *Director Disinterest and Independence: The SLC- Which way to Go?*, 1442 PLI/CORP 653, *666 (Sept.-Oct. 2004).
[113] *Martha Stewart*, 845 A.2d at 1055.
[114] *Id.* ("We need not decide whether the substantive standard of independence in an SLC case differs from that in a presuit demand case.").

Delaware law regarding the SLC procedure.[115] For these lawyers, *Oracle* and *Martha Stewart*, taken together, suggest that Delaware courts will from now on apply a more searching inquiry into director independence in the SLC context than in the demand context.[116]

It is still too early to tell whether Delaware law is heading in that direction. In the nearly two years since *Martha Stewart* was decided, no reported Delaware opinion has considered the independence of an SLC. Despite this uncertainty, there are two reasons to doubt the suggestion that a more searching independence inquiry should apply in the SLC context than in the demand context.

First, as a textual matter, both the *Oracle* and *Martha Stewart* courts used nearly identical language in setting forth the test for director independence,[117] suggesting the same substantive standard of independence applies in both settings. It would be illogical for the court to use the same language in *Martha Stewart* as *Oracle* if it meant to apply a less exacting inquiry in the demand context.

Second, applying a more exacting standard of independence in the SLC context than in the demand context would be both unprincipled and disingenuous. If directors can be influenced by professional, social, and institutional relationships in the SLC context, why could directors not be influenced by the same things in the demand context? Such bias-producing relationships should be recognized in both contexts or in neither. Admittedly, there may be an additional reason in the SLC context to doubt independence that is not present in the demand context. In the SLC context, by hypothesis, demand has already been excused.[118] The SLC directors are appointed by a board, a majority of who either are interested or lack independence.[119] This fact notwithstanding, directors in *both* the demand and SLC contexts are faced with the same underlying decision: whether to approve a proposed suit against fellow directors. When faced with such a decision, directors in both contexts seem equally likely to be influenced by a "there but for the grace of God I go" empathy.[120] The notion that directors in the SLC context can be influenced by professional, social, and institutional relationships while directors in the demand context are not seems inconsistent and disingenuous.

Although Delaware courts may later make clear that a more exacting standard of independence applies in the SLC context than in the demand context, both textual and policy reasons suggest that today it does not. The differing treatment of professional,

[115] *See* Kistenbroker et al., *supra* note 112, at 659 (arguing that *Oracle* and *Martha Stewart*, read together "signal a significant change in Delaware law—one which seriously undermines the continued vitality of special litigation committees").
[116] *Id*. at 666-67.
[117] In examining independence, both cases purport to apply a "contextual" inquiry, *Oracle*, 824 A.2d at 939; *Martha Stewart*, 845 A.2d at 1049, asking whether the director is so "beholden" to an interested director; *Oracle*, 824 A.2d at 938; *Martha Stewart*, 845 A.2d at 1049, such that the director is unable to make her decision "based on the corporate merits of the issue before the board, rather than extraneous considerations or influences." *Oracle*, 824 A.2d at 938; *Martha Stewart*, 845 A.2d at 1049 (both citing *Aronson*).
[118] *Martha Stewart*, 845 A.2d at 1055.
[119] *Cf. Zapata*, 430 A.2d at 787 ("[W]e must be mindful that directors are passing judgment on fellow directors in the same corporation and fellow directors, in this instance, who designated to serve both as directors and [SLC] members.").
[120] *Id*.

social, and institutional relationships in *Martha Stewart* and *Oracle* can likely not be distinguished on substantive legal grounds.

3. Oracle and Martha Stewart must be distinguished on the Facts

Notwithstanding the Delaware Supreme Court's language, the procedural distinctions between pre-suit demand and SLC contexts alone should not explain the two courts' differing approaches to the effects of professional, social, and institutional ties on director independence. Despite the view of some practitioners, it is unlikely that *Martha Stewart* and *Oracle* together inaugurate some heightened substantive standard of director independence in the SLC context that takes these bias-producing relationships into greater account.

Instead, the *Oracle* and *Martha Stewart* courts' differing treatment of professional, social, and institutional ties seems more likely the result of factual distinctions. Or, as the court in *Martha Stewart* noted, "Aside from the procedural distinctions, the Stanford connections in *Oracle* are *factually* distinct from the relationships present here."[121]

In assessing the effects of professional, social, and institutional ties on director independence, the Delaware Supreme Court explicitly set out an ambiguous standard that turns upon "the nature of the relationship" and other unspecified "additional circumstances."[122] Now, more than ever, the effect of professional, social, and institutional relationships on director independence under Delaware law is a "fact-specific determination."[123] Given that different judges will find different facts material, indeterminacy will abound.

IV. THE INDETERMINACY SOLUTION TO DIRECTOR INDEPENDENCE

That Delaware law regarding the effects of professional, social, and institutional relationships on director independence is ambiguous and indeterminate is perhaps a non-controversial claim. Many scholars have noted Delaware's penchant for adopting indeterminate legal standards[124]—a point with which even Delaware judges concur.[125]

The debate has instead centered on the desirability of such an approach. Detractors criticize Delaware's standard-based law for its unpredictability: vague, open-ended standards make the ex ante prediction of legal outcomes difficult.[126] This legal uncertainty, in turn, complicates business planning, promotes costly litigation, and even suppresses state competition for corporate charters.[127] Proponents of Delaware's

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[121] *Martha Stewart*, 845 A.2d at 1055 (emphasis added).
[122] *Id.* at 1051.
[123] *Id.* at 1049.
[124] *See, e.g.*, Kamar, *supra* note 54, at 1915.
[125] *See, e.g.*, Leo E. Strine, Jr., *Delaware's Corporate-Law System*, 86 CORNELL L. REV. 1257, 1265 (2001) (conceding that "in many ways Delaware corporation law is less than optimally clear"); E. Norman Veasay, *Juxtaposing Best Practices and Delaware Corporate Jurisprudence,* 18 INSIGHTS 5, 7 (Dec. 2004) (acknowledging that Delaware's corporate law "may be somewhat indeterminate").
[126] Kamar, *supra* note 54, at 1919.
[127] *Id*. at 1927-28, 1947.

standard-based approach, however, defend it for its flexibility and responsiveness to a constantly evolving business environment.[128]

Whatever the merits or demerits of Delaware's standards-based approach to corporate law in other contexts, this section argues that legal indeterminacy is the best approach in the context of director independence. This argument is made in two parts. First, Part A shows that a rules-based approach to director independence is, depending on the rules, either undesirable or impossible. Second, Part B argues that, aside from being the only desirable or possible option, an indeterminate legal standard may actually have the beneficial effect of promoting self-enforcement among boards and their lawyers.

A. The Unsuitability of a Rule-Based Approach to Director Independence

Although bright-line rules may be preferable in other legal contexts, no bright-line rule can encapsulate the concept of independence. Given the vast breadth of human relationships, the effects of these relationships on independence cannot be reduced to a simple bright-line rule.

Suppose Delaware courts developed a rule-based approach to evaluate the effects of professional, social, and institutional relationships on director independence. At one end of the continuum, Delaware law could ignore professional, social, and institutional ties as potential sources of bias. But foolhardily ignoring these relationships would be turning a blind eye to a powerful source of influence on a director's decision-making. Such a result is ostensibly undesirable.

At the other end of the continuum, Delaware law could embrace professional, social, and institutional ties as possible sources of bias while holding that all directors with such ties lack independence. Yet this result would be equally undesirable. Social, professional, and institutional ties exist at some level in almost every boardroom in America.[129] If every such relationship was considered a possible source of bias, almost every director in America would likely lack independence. There would be "no logical terminus."[130] Moreover, close personal rapport and collegiality among directors may in fact promote desirable board behavior.[131] Thus, shareholders may want to actually encourage rather than discourage directors from forming such social and professional bonds. Although some particularly close professional, social, and institutional relationships may give reason to doubt independence, not all such ties need be disabling.

Assuming Delaware courts agree that both categorical rule-based approaches are undesirable, their final alternative would be to develop intricate bright-line rules to define director independence for specific situations based on the specific nature of the relationship. But no set of rules can cover the vast breadth of human interactions. Any attempt will quickly devolve into an indeterminate, fact-intensive analysis.

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[128] *See, e.g.*, Jill E. Fisch, *The Peculiar Role of Delaware Courts in the Competition for Corporate Charters*, 68 U. CIN. L. REV. 1061, 1077 (2000).

[129] *See* BEBCHUK & FRIED, *supra* note 38, at 27-34; Davis et al., *supra* note 41, at 356-62; *cf.* Eric Landau et al., *Director Independence: Impartiality or Isolation?*, 1418 PLI/CORP 111, 126 (2004) ("Personal relationships will always exist, because directors do not come to a board as strangers.").

[130] Michael P. Dooley & E. Norman Veasay, *The Role of the Board in Derivative Litigation*, 44 BUS. LAW. 503, 534 (1989).

[131] *See* Donald C. Langevoort, *The Human Nature of Corporate Boards: Law, Norms, and the Unintended Consequences of Independence and Accountability,* 89 GEO. L. J. 797, 810-814 (2001).

This final claim does is not speculative. Consider the recently revised listing standards of the NYSE which require a listed company to have majority of independent directors on the board[132] and then attempt to define independence by listing the specific types of relationships that compromise independence.[133] These revised NYSE standards are a real-world attempt at reducing independence into a defined set of bright-line rules.

Yet, even the NYSE rules explicitly recognize that "[i]t is not possible to anticipate, or explicitly to provide for, all circumstances that might signal [a lack of independence]."[134] Instead, the rules resort to a catchall category: Any director with a "material relationship with the listed company," including material "commercial, industrial, banking, consulting, legal, accounting, charitable and familial relationships, among others," lacks independence.[135] To determine whether a material relationship fits into this residual category, directors are required to "broadly consider all relevant facts and circumstances."[136] Despite the NYSE's efforts, the new listing standards essentially devolve into a generalized principle requiring a fact-specific inquiry, no different than Delaware's indeterminate legal standard. If the revised NYSE listing standards give any indication, an attempt to reduce independence into a set of bright-line rules is simply not possible.

B. The Benefits of Delaware's Indeterminate Standard

Beyond the undesirability or impossibility of a rules-based approach to director independence, an indeterminate standards-based approach can have an important policy benefit. The indeterminacy of Delaware law has given corporate boards and their lawyers a powerful incentive to closely scrutinize and self-police director independence, thereby giving rise to a self-enforced norm that reduces the need for judicial intervention.

1. The Hypothesized Self-Policing Effect of Indeterminacy

Critics often decry indeterminacy for raising the risks of litigation and judicial intervention into board actions.[137] Yet, there is good reason to believe that the theoretical *risk* of litigation and judicial intervention reduces *actual* litigation and judicial intervention. The theoretical possibility of a legal challenge and judicial intervention encourages boards to self-regulate to completely avoid such possibilities.

Boards and their lawyers dislike indeterminate legal standards because such standards make it difficult for them to accurately predict the legal consequences of their actions ex ante, thereby complicating business planning. Indeterminacy raises the risk that their action will be challenged and perhaps even invalidated by judicial intervention. To the extent boards can avoid legal indeterminacy, and the concomitant risks of litigation and

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[132] NYSE, Listed Company Manual § 303A.01 (2003) [hereinafter NYSE Listing Standard], *available at* http://www.nyse.com/Frameset.html?displayPage=/listed/1022221393251.html.
[133] NYSE Listing Standard § 303A.02(b). The NASDAQ has adopted similar listing standards. *See* NASDAQ Stock Mkt., Inc., Market Place Rules R. 4200(a)(15)(2003). For a summary of these rules see, Note, *And Now, the Independent Director! Have Congress, the NYSE, and NASDAQ Finally Figured Out How to Make the Independent Director Actually Work?* 117 HARV. L. REV. 2181, 2187-95 (2004).
[134] NYSE Listing Standard § 303A.02(a) commentary.
[135] NYSE Listing Standard § 303A.02(a); *id.*
[136] NYSE Listing Standard § 303A.02(a) commentary.
[137] *See, e.g.*, Kamar, *supra* note 54, at 1947.

judicial intervention, they would rationally seek to do so. Thus, when faced with the choice of having their actions scrutinized by a court applying (1) an indeterminate legal standard or (2) a more determinate (and favorable) standard, boards would rather choose the latter.

Applying this analysis to Delaware's indeterminate independence standard, one can quickly see how indeterminacy can promote a self-enforcing norm and ultimately reduce litigation. To the extent Delaware law is indeterminate with respect to the effect of professional, social, and institutional relationships on director independence, it *theoretically* encourages litigation and judicial intervention. Every time directors on a board share some professional, social, or institutional ties, a plaintiff-shareholder is likely to challenge the directors' independence. As the case law demonstrates, every so often Delaware courts will agree with the shareholders by either excusing demand or setting aside the recommendations of an SLC after considering directors' relationships.

Yet this *theoretical* risk of litigation and judicial intervention can also be easily avoided. Like in other contexts in Delaware's standards-based corporation law, the indeterminate independence standard does "allow for [*some*] ex ante planning by practitioners and boards . . . enabling them to minimize ex post litigation risks."[138] Boards can minimize the chances that shareholder demand will be excused or that the recommendations of an SLC will be defeated by ensuring that their purportedly independent directors are not entangled in any suspect professional, social, or institutional relationships in the first place. Although Delaware's indeterminate independence standard may tolerate some professional, social, and institutional relationships between directors, those relationships that "push the envelope" risk compromising independence.[139] To avoid this indeterminacy, prudent lawyers will advise boards to avoid nominating any directors with whom they share any suspect relationships.[140]

Thus, the *theoretical risk* imposed by indeterminacy promotes a self-policing norm that will *actually* reduce litigation and judicial intervention. The theoretical risk of litigation and judicial intervention creates a powerful incentive for boards to avoid appointing directors with whom they share suspect relationships in the first place. Because boards will avoid nominating directors with whom they share suspect relationships, shareholders are less likely to have grounds upon which to challenge director independence. And even if shareholders do challenge certain directors' independence, absent any suspect relationships, Delaware courts are significantly less likely to intervene. If boards and their lawyers plan carefully by ensuring that a majority of the board is independent *before* a shareholder suit is ever filed, no derivative suit should ever survive pre-suit demand. And even if they fail to plan preemptively, by nominating ad hoc directors to serve on the SLC, boards and their lawyers have a second chance to carefully choose candidates who are free of any suspect relationships.

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[138] Strine, *supra* note 125, at 1280.
[139] *Id*.
[140] Consider the advice of the former Chief Justice of the Delaware Supreme Court to corporate lawyers. He suggests that although it may be difficult to draw bright-line principles from Delaware's indeterminate law, lawyers should nonetheless "take heed, as a part of best practices" to avoid the risk of judicial intervention. Veasay, *supra* note 125, at 11.

Admittedly, some may be tempted look at cases like *Martha Stewart* and conclude that the theoretical risk judicial intervention is too low to serve as any kind of meaningful incentive for boards and their lawyers to self-police. Indeed, although *Martha Stewart* pays lip-service to the notion that professional, social, and institutional relationships can compromise a director's independence, the court ultimately held that Stewart's close personal friends and professional associates were sufficiently independent of her.

Of course, the most obvious response to this skepticism is *Oracle,* where the court explicitly held that two directors lacked independence because of their professional, social, and institutional relationships with an interested director. [141] To the extent that the Delaware Supreme Court recognizes *Oracle* as valid precedent, [142] the case serves as a powerful reminder to boards and their lawyers that such bias-producing relationships, given the right factual context, can compromise independence. Yet, even in *Martha Stewart*, the Delaware Supreme Court creates an incentive to avoid such relationships. Like Professor Edward Rock's "corporate law sermons" in the context of management-buyout cases,[143] *Martha Stewart* sets out guideposts for boards and their lawyers to consider when assessing whether certain relationships compromise a director's independence.[144] Thus, like Rock's "corporate law sermons," although *Martha Stewart* ultimately holds that the directors in question are independent from Stewart, it gives boards and their lawyers unambiguous notice that such professional, social, and institutional relationships can and may compromise independence in future cases.[145]

2. Substantiating the Hypothesized Self-Policing Effect of Indeterminacy

Unfortunately, the claim that the indeterminate legal standard of independence reduces litigation by promoting a self-enforcing norm is impossible to prove empirically. One cannot know about the claims that were never brought because the board had chosen its directors carefully, free of any suspect relationships.[146]

There is, however, some indirect evidence to support the proposition that the indeterminate legal standard of independence reduces litigation by promoting a self-enforcing norm. Laura Unger's story may perhaps be the most vivid evidence of this hypothesized self-enforcement in effect. Wanting to avoid the risk of judicial

[141] *See also supra* notes 67-74 and cases cited therein.
[142] Recall, the Delaware Supreme Court in *Martha Stewart* expressly recognized *Oracle.* Rather than overruling it, the court instead distinguished it on procedural and factual grounds. *Martha Stewart,* 845 A.2d at 1055.
[143] *See* Edward B. Rock, *Saints and Sinners: How Does Delaware Corporate Law Work?* 44 UCLA L. REV. 1009, 1016-17 (1997).
[144] *See, e.g.*, *Martha Stewart,* 845 A.2d at 1050 ("A variety of motivations, including friendship, may influence the [independence] inquiry); *id*. ("Some professional or personal friendships, which may border on or even exceed familial loyalty and closeness, may [compromise independence]"); *id*. at 1052 ("[A director lacks independence if she] would be more willing to risk … her reputation than risk the relationship with the interested director.").
[145] *Cf.* Rock, *supra* note 143, at 1053 (arguing that a court's ruling ultimately absolving directors of legal liability can still have potent normative effects on future behavior).
[146] *Cf.* Strine, *supra* note 125, at 1281 ("[I]t [is] at least worth pondering whether Delaware's norm-based approach has . . . provided solid and workable guidance to practitioners…. Litigated cases are the ones that are most studied. What is less often studied is the far greater number of transactions consummated without any … litigation.").

intervention, she withdrew herself from her company's SLC.[147] But her case is not the only example. Practitioner-oriented publications interpreting Delaware's independence jurisprudence now advise corporate lawyers to carefully scrutinize the independence of board members.[148] When evaluating new candidates for the board, directors and their lawyers are warned to "meticulously examine … non-financial ties, including personal and professional affiliations, [as well as any] secondary indirect financial ties that [may] exist."[149] Where an existing director's independence is potentially suspect, boards and their lawyers are advised to "carefully weigh the benefits and possible detriments of having the director in question continue to serve."[150] Likewise, Delaware judges themselves, in their extrajudicial writings and speeches are encouraging boards and their lawyers to "drill down" to closely scrutinize the backgrounds of their directors' independence ex ante, to prevent judicial intervention ex post.[151] Taken together, these data suggest that Delaware law is cultivating a self-enforcement norm where boards, with the aid of their lawyers, scrutinize themselves for any suspect relationships that could compromise independence.

3. The Advantages of Self-Enforcement coupled with Judicial Enforcement

Of course the most obvious advantages of a self-enforcement regime would be the resulting reduction in litigation and demand on judicial resources. Despite these advantages, some may be understandably uneasy with a regime that leaves corporate directors, rather than courts, with the responsibility of assessing their own independence. Yet, a critical advantage of a self-enforcement regime is that boards and their lawyers are better able to weed out suspect directors than courts. Those within a corporation have a relative advantage over judges in detecting bias-inducing professional, social and institutional ties among board members and, once detected, to frankly assess their effects on independence. Moreover, the self-enforcement regime created by an indeterminate legal standard merely supplements the courts' role; it does not replace it.

Judges are at a comparative disadvantage to the directors themselves at detecting professional, social and institutional ties. Unlike economic and familial ties, professional, social and institutional ties are much more difficult to detect. Two directors' longtime friendship or frequent social contacts are not written into a business contract or revealed in an SEC disclosure. Two directors' extensive institutional ties or shared political interests are not revealed by simply looking to see if they share a common last name. When compared to the directors themselves, judges, and indeed litigants, are in a substantially worse position to detect many of the bias-inducing professional, social and institutional ties that may taint independence.

And even when detected, judges are at a comparative disadvantage in assessing the effects of such ties on a director's independence. Judges can look to the dollar-value of a contract to assess the materiality of an economic relationship. Likewise, judges can look to the nominal nature of a familial relationship—be it father-son, brothers, or distant

[147] Harrington, *supra* note 1.
[148] *See, e.g.*, BNA CORPORATE PRACTICE SERIES, No. 79 § II (2005); Kistenbroker et al., *supra* note 112, at 667.
[149] Kistenbroker et al., *supra* note 112, at 667.
[150] BNA CORPORATE PRACTICE SERIES, NO. 79 § II (2005).
[151] *Oracle Case Judge Says Do Homework on Director Conflicts*, COMP. REP., Sept. 20, 2004 (reporting on speech given by Chancellor Strine); *see also supra* note 140.

cousins—to assess its closeness. But unlike economic and familial ties, there is no obvious or tangible proxy by which to gauge the potential influence of professional, social and institutional ties on a director's impartiality and objectivity. Such ties come in a broad spectrum that can only be assessed by imprecise and unhelpful descriptors like "close," "extensive," or "tenuous." Although plaintiffs may discover and allege specific facts to illustrate the nature of such relationships, isolated facts cannot capture the real-life nature of such personal relationships. The directors, in contrast, have lived through these relationships. Although it is arguable whether this puts them in a better position to assess the influence such relationships may have on their independent decision-making, their subjective knowledge of the relationship does inarguably put them in a better position to at least assess what a judge or other outside party, knowing all the facts they do, would think. Consider the words of Ms. Unger, who, while defending her "independence in fact," nonetheless conceded her "independence in appearance" was questionable.[152]

Given these comparative advantages, directors are better able to detect and assess possible sources of influence that judges or shareholder-plaintiffs might otherwise miss or fail to fully appreciate. Thus, directors and their lawyers, under a self-enforcement regime promoted by the indeterminate legal standard, are better able and more likely to weed out suspect directors that courts, applying the indeterminate legal standard, might otherwise sustain.

Finally, even if boards and their lawyers fail to accurately assess or attempt to deceive courts and shareholders about their suspect relationships, courts still serve as a final check on the self-enforcement regime. If, despite directors' incentive to self-police, shareholders still feel a purportedly independent director lacks independence because of his professional, social or institutional ties to an interested director, shareholders are still free to challenge the director's independence, and boards will again face the wrath of Delaware courts applying an indeterminate legal standard. The self-enforcement that arises from an indeterminate legal standard serves only as an initial check; it *supplements* rather than *replaces* judicial review.

CONCLUSION

As the case law demonstrates, Delaware law regarding director independence is rather indeterminate. Although the law has set comparatively clear outer limits, consistently holding that close familial and material economic relationships compromise independence, the inner contours of director independence—the effects of less tangible professional, social, and institutional relationships on director independence—have been rather murky.

Legal indeterminacy may be frustrating for corporate boards and lawyers. But indeterminacy is a practical solution to the intractable problem of assessing when and how professional, social, and institutional relationships among directors affect independence. Rather than courts hopelessly trying to define independence with bright-line rules, or shareholders trying to detect undisclosed bias-producing relationships among board members, or judges trying to assess the influence of these bias-producing

[152] Harrington, *supra* note 1.

relationships on a director's independence, indeterminacy encourages boards to self-police to avoid these suspect relationships altogether.