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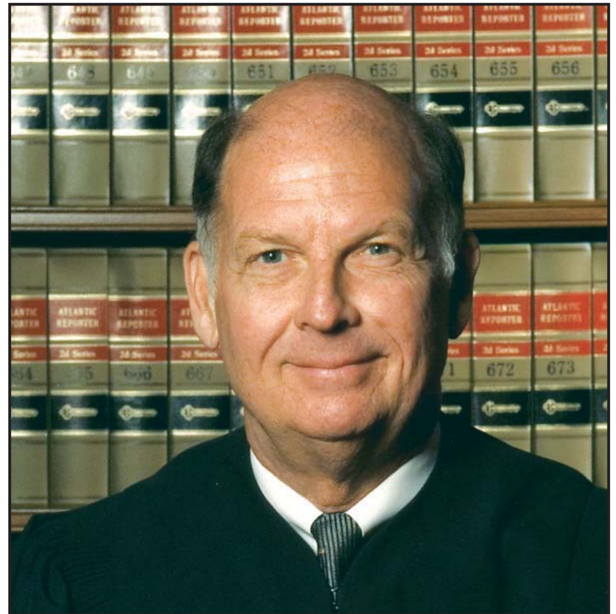
Why Delaware's Courts Attract U.S. And Foreign Companies – Fairness, Efficiency And Doctrinal Consistency

The Editor interviews ***The Honorable Myron T. Steele****, Chief Justice, Delaware Supreme Court.*



The Honorable Myron T. Steele

Editor: The U.S. Chamber of Commerce survey of counsel for corporations has again found Delaware to have the best court system.

Steele: Yes, the Chamber conducts an annual survey of in-house and outside counsel for corporations that ranks state court systems on the basis of fairness and efficiency. In its most recent survey, Delaware courts were again ranked number one. Because its rankings were from the perspective of the handling of cases involving tort liability, the Chamber focused on the fairness and efficiency of proceedings in our Superior Court, which is our court of general jurisdiction, and the extent to which our juries render verdicts that are fair. It is a compliment to the judicial system and the atmosphere in Delaware that we are able to empanel juries that are rational in their approach to business disputes.

Editor: How do its courts contribute to making Delaware an attractive business location?

Steele: Fairness is an important consideration. No one wants to be subjected to unknown speculative results that can be unconscionable. The courts in Delaware try to combine the perception and reality of fair access to the courts with efficiency in handling the dispute. Our judges go through a merit system selection process. They are not elected and our system is not politically skewed. Our state constitution requires that there be a balance in the political party affiliations of the judges on each of our courts.

Delaware courts have over many years developed great expertise in handling business issues. Our Court of Chancery is a business-focused court. It sits without a jury, which reduces the risk element by assuring that fact finding and the application of the law will be handled by judges skilled in resolving business disputes. Businesses can also have access to juries by using the Superior Court, our court of general jurisdiction, which has developed an expertise in handling class actions and jury-oriented fact finding in a way that focuses on the pleadings and early dismissal of frivolous cases. Summary judgement is used in a way that permits only cases with genuine issues of material fact to get to the jury.

Case management is a major focus of our judges. Not only is there a desire to move a dispute in and out of the system as quickly as possible, but there is also an emphasis on doing it as inexpensively as possible. For example, our judges are deeply involved in discovery management in an effort to reduce expense to and internal disruption of a litigating business.

Our emphasis on prompt dispute resolution at the lowest possible cost, coupled with predictability of outcome based on doctrinal consistency, is the way in which our court system contributes to making Delaware attractive.

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Delaware's Courts

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Editor: In this era of globalization are there aspects of Delaware's legal climate that make it particularly attractive to foreign-headquartered corporations — either as an incorporating jurisdiction for their subsidiaries and affiliates or as a business location?

Steele: Our job is to assure litigants that if they bring their disputes to Delaware they will have a level playing field. The Court of Chancery does not use juries so that both fact-finding and the application of the law in disputes arising out of M&A activity is in the hands of judges experienced in business matters. There is no reason to believe that any result will be skewed because one party comes from one part of the world as opposed to another.

We are continuing to see a great deal of M&A activity that is cross border using Delaware corporations to consummate the transactions. This occurs because foreign-based corporations prefer to have any disputes come before the Delaware courts.

Editor: Explain the role of the Delaware courts in resolving technology disputes?

Steele: As part of our philosophy to provide a full range of expert judicial services to meet business needs, our General Assembly created special jurisdiction in the Court of Chancery for technology disputes. This assures parties that the complexities of technology disputes will come before experienced judges who have been exposed to these types of cases over time. They bring their technology cases before this court just as they bring their patent cases to Delaware's Federal District Court because they know that the judges have the necessary specialized knowledge.

Editor: Some have said that Delaware courts are the most ADR friendly in the nation, Why is this? Have its mediation programs proven to be popular?

Steele: Delaware's judges and legislature believe that parties should be able to craft their own dispute resolution mechanisms without undue interference from government. Therefore, we encourage the use of ADR. It is offered within each of our courts, not just the Court of Chancery or the Superior Court. For example, the Family Court also has ADR as an option for the parties. In the Superior Court and Chancery Court one judge will mediate a dispute and then another judge will sit on the actual trial if there is one. There is no fear of cross-fertilization of ideas or other concerns that will make a party reluctant to mediate. The Court of Chancery will mediate a dispute over which they may not otherwise have jurisdiction if they have the consent of the parties. Thus, if the parties wish to avail themselves of the mediation services offered by our courts, they can do so even if they are not incorporated in Delaware.

Editor: Have the business judgement rule protections for directors under Delaware law been undermined by federal incursions through Sarbanes-Oxley and settlements exacted by prosecutors? Do you feel that these developments may make it more difficult for corporations to attract qualified directors?

Steele: My concerns continue. Recent enforcement actions of the SEC have been directed against independent directors on the theory that they failed to discharge their fiduciary duties. In doing so, their definition of an "independent director" is more restricted than that in Sarbanes-Oxley and their definition of the duties of loyalty and duty of care go beyond what is required by state laws. This represents a very broad incursion into what always has been considered the realm of the state courts, namely policing their own state-chartered corporations. Because the SEC's mandate is shareholder-oriented, it takes actions that, by ignoring the need to take into consideration the societal interest in preserving the business judgement rule's protection of directors, may deter talented individuals from serving on boards.

It is incumbent upon those at the SEC and others in the executive branch to balance (1) their desire for independent directors to play a more aggressive role as a check on corporate misconduct against (2) the perceptible chilling effect on the willingness of good people to serve as directors and on risk taking by those serving as directors. Executive branch actions can have a "shaming" effect or impose financial penalties for actions that would have been protected under the business judgement rule. This results in reducing the "gene pool" of those willing to serve as independent directors.

Those in the executive branch need to be more aware that the best-qualified people will refuse to serve or take risks for shareholders if they feel that they are putting themselves too much at risk personally. They must stand back and consider whether it is really in the interest of stockholders to create such a situation. They should understand that it is not only the direct effects of their actions that deter qualified people from serving and inhibits risk taking by those who serve, but also the indirect effects such as the increase in deductibles applicable to D&O insurance and the potential loss of director indemnification. The resolution of disputes involving business judgement rule considerations and the doctrinal growth in the definition of the fiduciary duties is best done on a case-by-case contextual basis by state courts rather than in particularized federal enforcement actions instituted and completely controlled by the executive branch.

Even if one assumes that the chilling effect of executive branch actions is arguable, it is distressing that the executive branch has not taken the time and spent the resources to determine whether increasing the risks of service as an independent director really serves the long term interests of shareholders and the corporation. It raises the issue of whether the SEC has become the captive of shareholders with short term interest in profit rather than those with an interest in enhancing long-term growth of the corporation.

Editor: What is the significance of the "good faith" test? Are there aspirational guidelines that will help directors avoid issues of "good faith?"

Steele: The current law in Delaware with respect to "good faith" is properly stated in Chancellor Chandler's opinion in *Disney* which is on appeal. It is only a short time before the Supreme Court will make a determination on that case. As the law stands today, the Chancellor's words are the Delaware definition of good faith until and if they may be modified by a Supreme Court opinion.

In *Disney,* the Chancellor provides very detailed and helpful aspirational guidelines. Those guidelines suggest that if directors focus on their duty of loyalty, remain independent (both in the sense that they can be objective and disinterested in that they don't have a financial interest in the outcome) and if they are careful in their decision-making process (by informing themselves properly about the decisions they are about to make), they will not have to worry about crossing the line of breaching any duty of "good faith" or face any question about whether any alleged failure of compliance with their duties of loyalty and due care was in "bad faith" – even if "good faith" is found to be an independent duty. It's not complicated. This is what investors expect and it is not a difficult standard to meet. If you have your eye on the ball it is almost intuitive that you are going to meet it. Counsel can find a copy of Chancellor Chandler's opinion on Delaware courts' website: http://courts.delaware.gov/opinions/(yngbs445h5zwzp45b2x04gvg)/download.aspx?ID=64510. When the *Disney* appeal is decided by the Supreme Court it will be placed on our website the very day it is issued.

Editor: Is there increased exposure for directors who may be financial experts? What aspirational rules should director-experts follow to avoid exposure to possible liability?

Steele: The case that is most pertinent to your question is *Emerging Communications*. We still consider in Delaware that the board is going to be examined as a whole to determine if it has discharged its responsibility. In special cases the independence of individual directors may be an issue. In a demand-excused demand-futile case, for example, you will find references to the relative independence or disinterestedness of each director. I do not think that *Emerging Communications* stands for the proposition that there are different thresholds of standards of care for individual directors based on their expertise.

With Sarbanes-Oxley, you now have an audit committee and a requirement that it be chaired by a person with special expertise in accounting. Whether or not that person discharges his or her fiduciary duties appropriately under Delaware law will still be examined under the same lens that we use with any other director. So there is no enhanced liability or scrutiny based on that director's background, training or expertise. You want people from different backgrounds on a board so you have different points of view. Any effort to impose special liability standards on different issues depending on individualized expertise and experience would become a nightmare. The board still governs as a whole and you have to examine them as a whole. That is my understanding of Delaware law as of this moment.

Editor: Directors' actions in approving executive compensation are getting greater attention by the courts. Can you suggest aspirational rules that should be followed by directors to avoid liability?

Steele: The Courts do not live in a vacuum. Everyone knows that significant attention is paid today to executive compensation. Investors and investor groups are asking questions about the extent to which executive compensation is out of whack with executive performance. The case law is beginning to suggest that it is not sufficient to look only at what others are paying in the same business sector and using that as a floor to which additional incentives are added. There is an argument that we are beginning to hear that the reason compensation has soared (and some people would argue disproportionately to performance) is because the metric is based solely on what comparable companies are paying. The shareholders' wealth is being spent on compensation and it's the judgement of the board as to how it should be spent and under what circumstances the best results will be obtained. Therefore, responsibility rests with the board to determine what compensation should be paid to top executives in order to provide them with an incentive to produce the best results for the company.

The aspirational rules that directors might follow include making sure that the metric for determining executive compensation is one that is constructed by the board and not one that is delivered by the CEO or his or her executive compensation advisors. Boards should take a very careful look at the source of the information about the compensation of others that is being used in developing the metric for determining compensation and be sure that it is derived independently from management. That does not necessarily mean that the board cannot rely on what management submits to them; it is only logical that they look at the information available, but directors also need to perform an independent inquiry into what methodologies are out there for basing their decisions.

In order to protect themselves from liability, directors should be faithful to their duty of care. They should make sure that they do not become the handmaidens of management in developing the metric for compensation and they should do some independent inquiry as to what methodologies and sources are out there on which they can base their decisions. They should use the information developed to clearly tie compensation in a meaningful way to performance, which will both result in fair compensation and incentivize management within reasonable parameters to perform for shareholders – that way they can satisfy shareholders because there is a logical basis for their decision making and it will be factually grounded in such a way that the courts can never second-guess their judgment.