10-1-2009

A Modest Proposal for Fixing Delaware's Broken Duty of Care

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Abstract: This paper proposes that Delaware could improve on existing, ineffective judicial mechanisms enforcing the duty of care by upgrading the ability of Delaware Chancery Court judges to comment on board decision processes. I suggest two possible reforms. First, Delaware Chancery Court judges could, in their discretion, award attorneys' fees to unsuccessful plaintiffs in duty of care cases. Second, Delaware could authorize judicial inquiries into credible allegations of gross negligence in board decisions.

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Delaware's duty of care is broken. Although that state purports to police against gross negligence by corporate directors, it does nothing of the sort. Delaware's judges and lawmakers have tried to fix the situation but without success. Worse, the fantasy that Delaware monitors director performance creates an unhealthy misconception that someone is minding the store.[2]

This paper offers a modest proposal for fixing Delaware's broken duty of care: Delaware could upgrade the ability of Chancery Court judges to comment on the quality of board decision-making processes. This objective might be accomplished in two ways. First, Chancery Court judges could, in their discretion, award attorneys' fees to unsuccessful plaintiffs in cases when the plaintiffs' efforts have conferred a benefit on the company by exposing and vetting claims of serious shortcomings in board decision processes. Second, Delaware could empower Chancery Court judges to conduct judicial

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[2] See Assaf Hamdani & Reinier Kraakman, Rewarding Outside Directors, 105 Mich. L. Rev. 1677, 1680 (2007) (noting the "widespread belief" that Delaware imposes meaningful remedies for mismanagement.).

inquiries into credible allegations of gross negligence and to issue reports evaluating the claims.

At the outset, I admit that my reference to the idea as "modest" is (partially) tongue-in-cheek. If implemented, it would *not* represent a modest reform, but rather would constitute a significant innovation in Delaware practice – perhaps not as dramatic as Swift's proposal to cook and eat Irish children, but still unusual for Delaware. But the proposal *is* modest in other respects. It does not pretend to eliminate bad decisions by corporate boards. Stupidity and fecklessness in the boardroom will survive any efforts to improve Delaware law. Further, I am under no illusion that the proposal will be implemented any time soon. I offer the concept instead as a thought experiment – a way to stimulate ideas about one of the more challenging puzzles in American corporate law.[3]

This paper is structured as follows. Part I discusses Delaware's efforts to enforce a duty of care through legal liability or judicial commentary. Part II addresses the question whether Chancery Court judges possess the capacity to effectively review managerial decision processes. Part III discusses two possible mechanisms for upgrading the ability of Chancery Court judges to engage in commentary in duty of care cases: changes in the rules pertaining to awards of attorneys' fees and judicial inquiries.

[3] See, e.g., Assaf Hamdani & Reinier Kraakman, Rewarding Outside Directors, 105 Mich. L. Rev. 1677, 1678 (2007) ("[t]he proper role of legal sanctions in motivating directorial oversight is one of the most difficult issues in corporate governance"); Renee M. Jones, Law, Norms, and the Breakdown of the Board: Promoting Accountability in Corporate Governance, 92 Iowa L. Rev. 105, 108 (2006) ("[a] puzzling aspect of corporate law is the absence of an effective enforcement mechanism for the duties of loyalty and care that form its traditional foundation").

I. Delaware's Regulation of Managerial Performance

Perhaps the most fundamental principle of corporate law is that directors direct. Except in unusual cases, members of the board of directors enjoy the power and responsibility to manage corporations.[4] Having conferred such a power, one might think that states, including Delaware, would penalize directors who fail to exercise due care in reaching important decisions. A first impression would confirm the expectation: Delaware does purport to police against gross negligence by corporate directors. But this is an illusion. Delaware offers no meaningful judicial regulation of managerial decision-making processes, either by way of legal liability or through moralistic criticism of director actions.[5]

A. Liability

The duty of care officially requires directors to exercise some degree of skill and diligence in the management of the companies they serve.[6] Directors who fail in this

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[4] Del. Code Ann. tit. 8, § 141(a).

[5] Commentators are unanimous, or nearly so, in observing that Delaware provides precious little judicial regulation of managerial performance. See, e.g., Ann M. Scarlett, A Better Approach For Balancing Authority and Accountability in Shareholder Derivative Litigation, 57 U. Kan. L. Rev. 39, 40 (2008) ("derivative litigation . . . rarely succeeds in holding directors liable for their decisions"); Assaf Hamdani & Reinier Kraakman, Rewarding Outside Directors, 105 Mich. L. Rev. 1677, 1687 (2007) ("directors currently face very little risk of liability for negligent oversight"); Renee M. Jones, Law, Norms, and the Breakdown of the Board: Promoting Accountability in Corporate Governance, 92 Iowa L. Rev. 105, 108 (2006) (it is "nearly impossible for shareholders to prevail when challenging the decisions and practices of corporate management"); Lynn A. Stout, On the Proper Motives for Corporate Directors (or, Why You Don't Want to Invite Homo Economicus to Join Your Board), 28 Del. J. Corp. L. 1, 7 (2003) (a director is "more likely to be attacked by killer bees than she is to have to ever pay damages for the breach of the duty of care"); Lyman Johnson, Rethinking Judicial Review of Director Care, 24 Del. J. Corp. L. 787, 805 (1999) ("there really is no director duty of care in the decision-making context in Delaware, at least beyond a duty simply to be informed.").

[6] Early formulations, drawn from the law of trusts, defined the directors' duty by a negligence standard: they were supposed to exercise reasonable care in their conduct of a corporation's affairs. For a traditional formulation drawn from the law of trusts, see Restatement of Trusts §174 (1935) (trustees owe a duty "to exercise such care and skill as a man of ordinary prudence would exercise in dealing with his own property"). Delaware imported the trust standard to the corporate law setting in Graham v. Allis-Chalmers Manufacturing Co., 188 A.2d 125 (Del. 1963) ("directors of a corporation in managing the corporate affairs

obligation are, in principle, liable to the corporation for money damages. In reality, however, the threat of money damages has little or no force in Delaware, for the following reasons:

1. Section 102(b)(7) of the General Corporation Law allows Delaware firms to enact charter amendments shielding directors from monetary liability for non-intentional breaches of the duty of care. All or virtually all public Delaware companies have opted out of liability, making the possibility of money damages for violations of the duty of care effectively a dead letter for many of the nation's largest firms.[7]

2. Corporations have long employed home remedies to insulate directors from mismanagement liability. They purchase policies of directors and officers liability insurance which not only commit to pay the costs of judgments but also promise to present a defense.[8] In addition, corporations frequently promise to indemnify directors for uninsured judgments in a duty of care case.[9] Although these protections are vestigial today in the duty of care context in light of the widespread pattern of opting-out under § 102(b)(7), they remain important as backups and as symbolic expressions of a company's intention to protect its directors against liability for unintended breaches of fiduciary duty.

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are bound to use that amount of care which ordinarily careful and prudent men would use in similar circumstances"). For discussion of the evolution of the duty of care standard, see Edward Rock & Michael Wachter, Dangerous Liaisons: Corporate Law, Trust Law, and Interdoctrinal Legal Transplants, 96 Nw. U. L. Rev. 651, 658 (2002).

[7] See Marcel Kahan & Edward B. Rock, How I Learned to Stop Worrying and Love the Pill: Adaptive Responses to Takeover Law, 69 U. Chi. L. Rev. 871, 889 (2002) ("widespread" adoption of charter amendments implementing § 102(b)(7)); Lawrence A. Hamermesh, Why I Do Not Teach Van Gorkom, 34 Ga. L. Rev. 477, 490 (2000) (98 out of 100 Fortune 500 companies that incorporated in jurisdictions allowing for exculpatory charter provisions adopted such provisions).

[8] See Sean J. Griffith, Uncovering a Gatekeeper: Why the SEC Should Mandate Disclosure of Details Concerning Directors' and Officers' Liability Insurance Policies, 154 U. Pa. L. Rev. 1147, 1168 (2006) (99% of surveyed U.S. companies had purchased D&O policies in 2004).

[9] See Tom Baker & Sean J. Griffith, The Missing Monitor in Corporate Governance: The Directors' & Officers' Liability Insurer, 95 Geo. L.J. 1795, 1822-23 (2007).

3. Delaware has elevated the substantive standard in duty of care cases to a level few derivative plaintiffs can reach. In 1984 the Supreme Court indicated that the standard is gross negligence.[10] But after a disastrous attempt to give teeth to the gross negligence standard in *Van Gorkom*,[11] the courts have demanded a much stronger showing of incompetence or neglect. *Disney* provides an example: despite evidence that the board had made serious errors in the decision processes leading to the hiring, compensating, and firing or Michael Ovitz, the Chancery Court and the Supreme Court held that the plaintiffs had failed to establish gross negligence.[12] While cases like *Disney* do not preclude a finding of gross negligence, they suggest that the bar has been set dauntingly high.

4. The Supreme Court has limited the types of conduct that could be considered grossly negligent. *Van Gorkom* could have been read as holding that liability could attach for matters of substance, such as agreeing to sell the company for an unreasonably low price. Later decisions made clear, however, that courts may consider only whether board members acted in good faith or failed to inform themselves or properly deliberate about the transaction.[13] Substantive review is out.

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[10] Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984).

[11] 488 A.2d 858 (Del. 1985). Many commentators sharply criticized the decision, finding it astounding that Delaware judges would fault a board of directors for agreeing in good faith to a merger at a substantial premium over the market price – and make the directors pay damages out of their personal assets to boot. See, e.g., Daniel R. Fischel, The Business Judgment Rule and the Trans Union Case, 40 Bus. Law. 1437, 1455 (1985).

[12] In re Walt Disney Co. Derivative Litig., 907 A.2d 962 (Del. Ch. 2005), aff'd, In re Walt Disney Co. Derivative Litig., 906 A.2d 27 (Del. 2006).

[13] See Cinerama, Inc. v. Technicolor, Inc. 663 A.2d 1156, 1162-63 (Del. 1995); Cede & Co. v. Technicolor, Inc., 634 A.2d 345 (Del. 1993). The requirement to be adequately informed includes the *Caremark* duty to implement procedures for acquiring and processing information pertinent to risks facing the company. See In re Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 968-70 (Del. Ch. 1996); Stone v. Ritter, 911 A.2d 362 (Del. 2006) (reaffirming board's oversight duties). For an interesting analysis, see Lyman Johnson, Rethinking Judicial Review of Director Care, 24 Del. J. Corp. L. 787 (1999).

5. The Supreme Court has held that proof of gross negligence does not in itself establish liability, but instead only overcomes the Business Judgment Rule presumption that the directors' actions were proper. Even if gross negligence is shown a director can defend on the ground that transaction was entirely fair to the corporation.[14] The entire fairness test gives directors another shield to use against claims of monetary liability for mismanagement.

6. Plaintiffs cannot avoid the Business Judgment Rule and § 102(b)(7) by reframing due care claims as violations of the duty of good faith. The plaintiff in *Disney* case tested this theory,[15] but the Supreme Court held that bad faith involves an element of intentional misconduct that is lacking in an ordinary duty of care case.[16]

7. Exacerbating the impact of the *Disney* decision is the message the case sent to plaintiffs' attorneys. Lawyers from the Milberg Weiss firm expended millions of dollars on the litigation and wound up with nothing. In the wake of *Disney*, few plaintiffs' attorneys are likely to have the resources and intestinal fortitude to undertake a duty of care case. We are just as unlikely to see another *Disney* as another *Van Gorkom*.

B. Judicial Commentary

Notwithstanding the lack of enforcement through legal liability, the Delaware courts do monitor directors to some extent by another means. As demonstrated in Edward Rock's article, *Saints and Sinners: How Does Delaware Corporate Law*

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[14] See Cinerama, Inc. v. Technicolor, Inc. 663 A.2d 1156 (Del. 1995); In re Walt Disney Co. Derivative Litigation, 906 A.2d 27, 52 (Del. 2006).

[15] See Lisa Fairfax, Spare The Rod, Spoil The Director? Revitalizing Directors' Fiduciary Duty Through Legal Liability, 42 Houston Law Review 393, 417 n.133 (2005) (the allegations in the complaint appeared "remarkably similar to duty of care claims").

[16] In re Walt Disney Co. Derivative Litig., 906 A.2d 27, 66 (Del. 2006).

Work?,[17] Delaware judges sometimes engage in moralistic commentaries when deciding fiduciary duty cases.[18] They deliver "corporate law sermons"[19] – "richly detailed and judgmental factual recitations, combined with explicitly judgmental conclusions, which sometimes impose legal sanctions but surprisingly often do not."[20] Rock applauds this practice on the ground that the critiques establish and enforce beneficial norms of conduct within the tight-knit world of the corporate bar and directors of public companies.

Chancellor Chandler's opinion in the *Disney* case illustrates Rock's thesis.[21] The Chancellor could easily have drafted a dry and scholarly opinion, short on facts, restrained in tone, which quickly reached the judgment that the plaintiffs failed to establish their case under applicable law. The actual opinion was different – florid in its language and caustic in its judgments. Chandler's description of Michael Eisner as "the omnipotent and infallible monarch of his personal Magic Kingdom"[22] is already fixed in the business law canon – not quite as memorable, perhaps, as Cardozo's "punctilio of an honor the most sensitive,"[23] but not far behind.

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[17] E.g., Edward B. Rock, Saints and Sinners: How Does Delaware Corporate Law Work?, 44 UCLA L. Rev. 1009 (1997).

[18] Others have noted the moralistic quality of Delaware decisions. See, e.g., William J. Carney & George B. Shepherd, The Mystery Of Delaware Law's Continuing Success, 2009 U. Ill. L. Rev. 1, 73 (2009) (Delaware decisions are "rich and lengthy morality tales").

[19] Edward B. Rock, Saints and Sinners: How Does Delaware Corporate Law Work?, 44 UCLA L. Rev. 1009, 1016 (1997).

[20] Id.

[21] For other examples, see, e.g., Kahn v. Tremont Corp., 694 A.2d 422, 429-30 (Del. 1997) (directors "abdicated their responsibility"); Paramount Communications Inc. v. QVC Network Inc., 637 A.2d 34, 50 (Del. 1994) (directors "remained prisoners of their own misconceptions"); Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261, 1280 (Del. 1988) (board was "torpid, if not supine"); Rabkin v. Philip A. Hunt Chemical Corp., 498 A.2d 1099, 1106 (Del. 1985) (special litigation committee engaged in a "quick surrender" when faced with a squeeze-out offer by controlling shareholder).

[22] In re Walt Disney Co. Derivative Litigation, 907 A.2d 693, 763 (Del.Ch. 2005).

[23] Meinhard v. Salmon, 164 N.E. 545, 249 N.Y. 458, 464 (1928).

As Rock and others demonstrate, there is reason to suppose that moralistic judgments contained in Delaware legal opinions do influence corporate directors. Directors value their reputations.[24] They operate in the tight-knight group where the esteem of others in the community is likely to be especially salient.[25] They are, accordingly, vulnerable to shaming sanctions.[26] Delaware judges are well-positioned to administer such sanctions: they are known for their expertise, enjoy prestige in the relevant community,[27] and bring an impartial judgment to bear that cannot be dismissed as the product of bias or rivalry.[28]

Two effects of judicial commentaries on managerial conduct are most salient. First, directors may be motivated, not only by a desire for pecuniary rewards, but also by

[24] See, e.g., Jonathan Macey, Delaware: Home of the World's Most Expensive Raincoat, 33 Hofstra L. Rev. 1131, 1134 (2005) ("[Directors] do not like to be made the object of public scorn and ridicule"). The literature on reputational sanctions is vast and growing. For a sampling, see, e.g., Dan M. Kahan, What's Really Wrong with Shaming Sanctions, 84 Tex. L. Rev. 2075 (2006) (arguing against shaming sanctions); Dan M. Kahan, What Do Alternative Sanctions Mean?, 63 U. Chi. L. Rev. 591 (1996) (arguing in favor of "shaming" over incarceration with respect to "white collar" criminals); Note, Shame, Stigma, and Crime: Evaluating the Efficacy of Shaming Sanctions in Criminal Law, 116 Harv. L. Rev. 2186, 2187 (2003) (considering efficacy of shame sanctions in criminal law context).

[25] See David A. Skeel, Jr., Shaming in Corporate Law, 149 U. Pa. L. Rev. 1811, 1812 (2001) (shame sanctions are most effective in tightly-bound communities with shared values); Edward B. Rock, Saints and Sinners: How Does Delaware Corporate Law Work?, 44 UCLA L. Rev. 1009, 1013 (1997) (senior management of Delaware corporations forms a surprisingly small community).

[26] E.g., Sandeep Gopalan, Shame Sanctions and Excessive CEO Pay, 32 Del. J. Corp. L. 757 (2007) (arguing that increased disclosure of executive compensation agreements will trigger emotions like shame, guilt and embarrassment); David A. Skeel, Shaming in Corporate Law, 149 U. Pa. L. Rev. 1811, 1854-57 (2001) (a judge can shame an offending director by explicitly criticizing her in the published opinion); Edward B. Rock, Saints and Sinners: How Does Delaware Corporate Law Work?, 44 UCLA L. Rev. 1009, 1039 (1997) (noting reputational costs of criticism by Delaware judges).

[27] See Edward B. Rock, Saints and Sinners: How Does Delaware Corporate Law Work?, 44 UCLA L. Rev. 1009, 1013 (1997) (opinions of the Delaware Chancery Court are influential in the development, maintenance and loss of reputation); Faith Stevelman Kahn, Regulatory Competition, Choice of Forum, and Delaware's Stake in Corporate Law, 34 Delaware Journal of Corporate Law 57, 71 (2009) (same); Demetrious G. Kaouris, Is Delaware Still a Haven for Incorporation?, 20 Del. J. Corp. L. 965, 975 n.59 (reporting remarks of Chief Justice Rehnquist that "Corporate lawyers across the United States have praised the expertise of the Court of Chancery, noting that since the turn of the century, it has handed down thousands of opinions interpreting virtually every provision of Delaware's corporate law statute. No other state can make such a claim").

[28] Edward B. Rock, Saints and Sinners: How Does Delaware Corporate Law Work?, 44 UCLA L. Rev. 1009, 1013 (1997) ("Delaware courts provide a supplemental source of gossip, criticism, and sanction for this set of actors who are beyond the reach of the firm's normal systems of social control.").

a wish to act according to appropriate norms of behavior.[29] Judicial commentaries can help define norms for good boardroom behavior which provide valuable guidance to directors faced with difficult decisions. Second, the fear of being criticized in a judicial opinion may encourage directors to exercise greater diligence and care in the performance of their duties.

The judicial commentary option thus offers some potential to function as a parallel system of scrutiny and oversight – one that makes up, at least to some extent, for the lack of legal liability for violations of the duty of care. As currently administered, however, judicial commentary is subject to defects that makes it ineffective as an oversight mechanism:

1. The authority of judges to engage in gratuitous commentary is unclear. Judges are supposed to explain why a plaintiff did or did not obtain relief under the law. They are not supposed to engage in free-floating inquisitions or offer unsolicited advice. It is perhaps for this reason that comments on managerial performance in Delaware opinions sometimes seem like judicial Tourette's Syndrome – imprecations oddly disconnected from the lawyerly discussion in which they are embedded.

2. Judicial commentary tends to have a moralistic quality: the courts seem to be making normative judgments about the ethics and propriety of the directors' conduct, rather than assessing whether the conduct in question did or did not meet the applicable legal standard. Possibly this moralistic quality stems from the fact that under the Business Judgment Rule Delaware judges disclaim the ability to second-guess directors'

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[29] See Melvin A. Eisenberg, Corporate Law and Social Norms, 99 Colum. L. Rev. 1253 (1999) (arguing that corporate actors are motivated less by the desire to avoid liability than by the joint effect of social norms and the correlative prospect of financial gain in the market); Lynn A. Stout, On The Proper Motives of Corporate Directors (Or, Why You Don't Want To Invite Homo Economicus To Join Your Board), 28 Del. J. Corp. L. 1 (2003).

decision-making. To avoid the appearance of engaging in business judgments, the courts fall back on moralizing. But moralizing might not be as helpful for articulating standards for managerial conduct as straightforward discussions of the appropriateness of the directors' decision processes.

3. Judicial critiques of director behavior send a mixed message when issued in the midst of opinions which refuse to impose liability.[30] Given that the court did not actually impose liability, the subtext seems to be that notwithstanding the criticisms contained in the opinion, the conduct in question was not that bad. Judicial commentary, in this respect, might even exacerbate the situation because it only highlights how far directors can go. Despite all the shortcomings highlighted in Chancellor Chandler's opinion, Disney's board members did not have to reach into their wallets.

4. Judicial commentary will not work if cases are not brought. But claims of mismanagement are only brought if there is a realistic hope for attorneys' fees. To get a fee, an attorney must to prevail in the case, at least to some extent. Given the obstacles noted above to winning a liability case based on the duty of care, few lawyers will bring such cases. No cases, no commentary.

5. Even when cases are brought, they will only rarely reach the judge in a posture that allows for criticisms of director behavior. *Disney* was unusual in that it went to a full-scale trial. Most cases settle; and the settlement will not usually offer the judge the ability to make factual findings supporting his or her critique. The judge, moreover, is likely to be constrained by a clause in the settlement agreement under which the defendants admit no fault. Faced with such a clause, the judge is likely to have little

[30] See Renee M. Jones, Law, Norms, and The Breakdown of the Board: Promoting Accountability in Corporate Governance, 92 Iowa L. Rev. 105, 131 (2006).

basis on which to offer his or her opinions about the quality of management's decision processes.

II. Judicial Capacity

The upshot is that neither liability nor commentary offers effective judicial oversight of managerial decision processes. The question then arises whether Delaware law might usefully be reformed to increase the effectiveness of judicial oversight.

One possible answer is that *nothing* should be done. The justification for inaction is that Delaware courts lack the ability to monitor director conduct.[31] Lacking business judgment, courts will only make things worse if they try to intervene. The marketplace, not the courthouse, should therefore be the monitor of director quality.

Although there is force to this argument, I believe that it goes too far in removing the courts from any role in monitoring managerial quality. We certainly do not want judges running corporations. Nor do we want judges sniping at ordinary exercises of business judgment. On the other hand, I believe that judges *can* have a constructive role to play as backstops when it comes to requiring that boards adequately inform themselves about the decisions they undertake and engage in proper deliberations.

The potentially constructive role for Delaware Chancery Court judges flows from their unique perspective and expertise in corporate law matters. These jurists are vertically integrated dealers in fiduciary duties. They manufacture rules and purvey them to litigants in hundreds of cases.[32] The product of their efforts, in the form of opinions

[31] An observation extending back at least as far as Dodge v. Ford Motor Co., 170 N.W. 668, 684 (Mich. 1919) ("judges are not business experts"). For modern expressions of the same idea, see, e.g., Douglas M. Branson, Lecture, The Rule That Isn't A Rule -- The Business Judgment Rule, 36 Val. U. L. Rev. 631, 631 (2002).
[32] See Marcel Kahan & Edward Rock, Symbiotic Federalism and the Structure of Corporate Law, 58 Vanderbilt Law Review 1573, 1591 (2005) (commenting on the "extent to which important and controversial legal rules are promulgated by the judiciary, rather than enacted by the legislature.")

analyzing the duties of corporate directors in many different settings, is the lifeblood of American corporate law.[33] In sitting on fiduciary duty cases, moreover, Chancery Court judges gain extraordinary expertise in corporate law matters.[34] Their knowledge goes beyond the development and articulation of abstract legal principles. They also have extensive exposure to boardroom culture and management practices. They analyze complex deals, receive testimony about internal affairs, and read the minutes, briefing papers and other documents prepared for board meetings. They learn about how boards formulate questions, set their agendas, investigate issues, identify options, deliberate on proposed actions, and follow through on decisions once made.

The information set available to Chancery Court judges is in some respects superior to that available to other observers. Businesspeople know about a particular company in a particular industry but do not necessarily understand much about other companies and other industries. Judges, on the other hand, sit on many cases and gain exposure to a range of industries. Their knowledge, while thinner with respect to individual firms, is also more general and systematic than the knowledge of most businesspeople.

Judges also have the ability to probe more deeply than other observers. A governance scholar might have systematic knowledge about corporate decision processes – wider than that possessed by judges who see exceptional rather than routine cases. But scholars lack the power of compulsory access to information. A judge, in contrast, can

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[33] Delaware judges themselves tout their abilities in this respect. See, e.g., E. Norman Veasey & Christine T. Di Guglielmo, What Happened in Delaware Corporate Law and Governance from 1992-2004? A Retrospective on Some Key Developments, 153 U.Pa. L. Rev. 1399, 1408 (2005) ("the Delaware Supreme Court is certainly 'infallible' in the sense that it is the final word in corporate law.").

[34] See Faith Stevelman Kahn, Regulatory Competition, Choice of Forum, and Delaware's Stake in Corporate Law, 34 Delaware Journal of Corporate Law 57, 71 (2009); Roberta Romano, Law as a Product: Some Pieces of the Incorporation Puzzle, 1 J.L. Econ. & Org. 225 (1985).

lift the veil of the boardroom, receive testimony under oath about the events that occurred there, and review confidential documents which were never intended to see the light of day.

Judges are also impartial. They have no interest other than achieving a correct outcome. Most other observers lack this advantage. The company's counsel may serve at the pleasure of the directors or may be angling for promotion. Outside law firms and investment bankers want fees. Securities analysts are subject to conflicts of interest and lack a reliable window into the inner workings of the board. Even the company's outside auditors have an interest in catering to the wishes of the managers who have retained them. Judges, in contrast, possess the impartiality that comes with the independence of their office.

Given their extensive expertise and background in corporate decision processes, it is clear that Chancery Court judges have the ability to judge whether the board adequately informed itself of the issues pertinent to a matter brought before them for action and engaged in due deliberations on the matter under review.

III. Approaches to Enhanced Judicial Monitoring

If we accept that Chancery Court judges have the sophistication and judgment to assess whether the board adequately informed itself and exercised proper deliberations, the question becomes whether and how the law might be reformed in order to draw on that knowledge for the benefit of Delaware corporations.

One possibility is to make directors actually pay for acts of gross negligence.[35] If directors faced a genuine risk of personal liability they might display more diligence in

[35] For a proposal to this effect, see Lisa Fairfax, Spare The Rod, Spoil The Director? Revitalizing Directors' Fiduciary Duty Through Legal Liability, 42 Houston Law Review 393 (2005).

investigating proposed decisions and might think twice before signing on to proposals which in their hearts they view as bad for the companies they serve.

The idea of imposing genuine damages liability for acts of mismanagement is subject to serious objections, however. Politically it is a non-starter: Delaware public corporations have massively manifested their wish to exempt directors from personal liability for good faith breaches of the duty of care, and it is nearly inconceivable that the Delaware legislature would attempt to remove an immunity previously conferred. Even if such a reform were feasible, it might not be wise. Given the complex and overlapping protections available to managers in the form of liability insurance and indemnification, it would be difficult to devise a system that would actually put the directors' personal assets at risk in duty of care lawsuits. The dynamics of derivative litigation, which almost always results in settlement, will usually result in compromises within the liability insurance limits and without an acknowledgement of fault by the defendant directors. If a director did face potential personal liability, companies would seek ways to remove the sting, either through indemnification agreements or, if these are prohibited, through other forms of compensation. Even if all these obstacles could be overcome – if directors really were placed in jeopardy of having to pay from their personal resources for acts of gross negligence – it is not clear that we would wish to impose such liability. Fear of overwhelming judgments against directors for a good decision gone wrong might deter people from serving on corporate boards,[36] or might discourage them from undertaking risky but desirable ventures if they do serve.[37]

These considerations suggest that a more promising means for fixing Delaware's broken duty of care is to upgrade the judicial commentary remedy. The following sections examine the pros and cons of two ideas for facilitating this result.

A. Attorneys' Fees for Unsuccessful Litigants

First, Delaware Chancery Court judges could exercise discretion to award attorneys' fees to derivative plaintiffs in duty of care cases, *even if the plaintiff is unsuccessful at establishing liability*, if in the court's opinion the plaintiff has performed a service to the corporation by bringing credible allegations of gross negligence to the court for review.

Awarding fees to an unsuccessful plaintiff, although certainly unusual, is not fundamentally inconsistent with the spirit of Delaware's fee jurisprudence in corporate cases. Even if no monetary relief has been obtained, Delaware judges often award fees to successful plaintiffs, payable from the corporate treasury, based on a "common benefit" theory. The idea is that the litigation has conferred a benefit on the corporation that justifies compensation for the plaintiff's litigation costs.[38]

In some cases there is precious little substance to the "common benefit" that is cited as the justification for awarding fees to plaintiffs' counsel. An example is *Citron v.*

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[36] Concern about deterring people from serving on boards is a rationale frequently expressed for the shield of the business judgment rule. See, e.g., S. Samuel Arsht, The Business Judgment Rule Revisited, 8 Hofstra L. Rev. 93 (1979).

[37] This is also a common justification for the Business Judgment Rule. See, e.g., Frank H. Easterbrook & Gregg A. Jarrell, Do Targets Gain from Defeating Tender Offers?, 59 N.Y.U. L. Rev. 277, 277 ("The business judgment rule gives managers the freedom to err, and thus it facilitates risk-taking").

[38] See, e.g., Allied Artists Pictures Corp. v. Baron, 413 A.2d 876, 878 (Del.1980) (recognizing a longstanding Delaware policy to insure that "even without a favorable adjudication, counsel will be compensated for the beneficial results they produced.").

Burns.[39] The plaintiff challenged the company's agreement to repurchase stock from a corporate raider. Eventually the parties settled, with the company agreeing not to make block repurchases over any twelve month period without the prior approval of a majority of the non-management directors. This relief was essentially meaningless. The company had already engaged in a similar procedure, without any judicial compulsion, in the very stock repurchase that the derivative plaintiff was challenging. Moreover, it was highly unlikely that the company, even without the settlement agreement, would undertake an action over the opposition of a majority of its independent directors. Notwithstanding that the "relief" was a gossamer thread with no real substance, the Chancery Court awarded attorneys' fees to the derivative plaintiff, observing that "with respect to the claim for counsel fees, I again recognize the standing and ability of plaintiff's local and New York counsel in corporate litigation. This factor together with the contingent nature of the representation and the benefit conferred suggest that full compensation is justified. Although the discovery effort of plaintiff's counsel has not been extensive it has been directed to the nub of defendant's business judgment defense."[40] In other words, counsel was compensated for litigating the issue of business judgment.

Numerous other Delaware decisions award fees for obtaining relief which is charitably described as "therapeutic."[41] In many of these cases, the Chancery Court

[39] 1985 WL 11533 (Del.Ch. 1985).
[40] Id.
[41] See, e.g., In re Nat. City Corp. Shareholders Litigation, 2009 WL 2425389 (Del.Ch., July 31, 2009) (awarding fees for settlement of challenge to merger which resulted only in supplemental disclosures to shareholders); Kosseff v. Ciocia, 2009 WL 608549 (Del.Ch., February 26, 2009) (awarding fees based on "therapeutic" benefit of settlement); In re Golden State Bancorp, Inc. Shareholders Litig., 2000 WL 62964 (Del. Ch. Jan. 7, 2000) (awarding fee for corrective disclosure); PaineWebber R & D Partners II, L.P. v. Centocor, Inc., 2000 WL 130632 (Del.Ch., January 31, 2000) (awarding fees to an objector whose efforts

awarded fees to plaintiffs who had, in effect, lost the litigation – who had settled for nothing more than a fig leaf to cover the fact that no substantial relief was obtained at all. The fees were awarded, we may infer, because the court felt that counsel had provided some benefit to the corporation by conducting the litigation. But if fees can be awarded to plaintiffs who in every meaningful sense lost their cases, even though they could doctor up a settlement agreement as a partial victory, it is only a small step to say that fees can be awarded to parties who *in fact* lost the litigation, but whose efforts conferred benefits on the corporation by exploring credible charges that the decision-making processes at the firm failed to live up to the standards one would expect from well-managed firms.

A publicly-announced policy of awarding fees to losing litigants in situations such as this could help correct for the fatal flaw in the current judicial commentary remedy. Courts cannot engage in commentary if they do not have cases, and cases will not be brought if the attorney does not anticipate a fee. But if attorneys could obtain a fee for litigating a duty of care case *well*, even if they are not ultimately successful in establishing liability, they might be more willing to bring such cases in the first place.

The strategy of awarding fees to unsuccessful derivative is worthy of consideration as an approach to revitalizing the duty of care, especially because it involves only a minor adjustment to current Delaware practice. But the effect of such a reform is also likely to be relatively small. First, Delaware courts would retain discretion to *deny* fees in unsuccessful cases, or to award less in fees than counsel requests. They have a habit of awarding niggardly fees in cases generating therapeutic relief, and they

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resulted in "no more than an arguable therapeutic benefit to the class"); In re Diamond Shamrock Corp., 1988 WL 94752 (Del. Ch. Sept. 14, 1988) (awarding fee for corrective disclosure).

might be even less generous when the case fails completely. Second, there remains the danger of settlement: if, as often happens, the parties settle with no admission of misconduct, the court would lack a sufficient basis for making judgments about the quality of the director's decision processes. Third, because these cases would be premised on the claim that the defendants had violated a legal obligation, the court's evaluation of director conduct would tend to be focused on the legal standard – again impeding the ability of the judge to make general judgments about director decision processes. Despite these limitations, the option of awarding fees to losing derivative plaintiffs in duty of care cases offers potential to improving the performance of Delaware corporations.

B. Judicial Inquiries

An alternative approach is the judicial inquiry: an official investigation into plausible claims of gross negligence coupled with a public report on the results of that review.

1. The Procedure

I envisage the following procedure, which would need to be authorized by the Delaware legislature.[42] Any person (the "relator") could file a petition containing

[42] The model set forth here is only one of many approaches. It envisages an inquiry conducted by a single judge using procedures similar to those already familiar in shareholders derivative litigation. But judicial inquiries could also be conducted by panels of fact-finders. It is not essential, moreover, that the inquiries be conducted by judges. Although members of the judiciary have certain advantages, any reputable and qualified person could perform the task. And the procedures used in judicial inquiries do not have to be similar to those of a trial. For example, the judge could take a more active role in structuring the inquiry, perhaps emulating the inquisitorial style of judging found in continental Europe. See John H. Langbein, The German Advantage in Civil Procedure, 52 U. Chi. L. Rev. 823, 834 (1985). The model put forward here is advanced in the hope of focusing discussion and stimulating thought about innovative ways for enhancing the monitoring of director decision processes.

particularized allegations of gross negligence and requesting an inquiry.[43] The relator would serve notice on the corporation and its directors, who would be afforded reasonable time to file oppositions providing reasons why an inquiry should not be held. The petition and any opposing papers would be assigned to a Chancery Court judge, who would evaluate whether the facts alleged in the petition would, if true, support a plausible inference of gross negligence. If the judge concludes that the petition is insufficiently specific, or that the facts alleged do not support a plausible inference of gross negligence, then he or she would reject the request for an inquiry. If the petition survives this threshold, then the judge would consider whether, going forward, a judicial inquiry would likely improve the management of the company or of Delaware corporations across the board. If the judge concludes that the answer to this second question is yes, he or she would initiate an inquiry. If the answer is no he or she would reject the petition.

If the Chancery Court judge determined to initiate an inquiry, he or she would select counsel to present the facts and arguments against the accused directors. The matter would presumptively be assigned to someone proposed by the relator; but if the court could also appoint different counsel. The relator's counsel would conduct discovery, including document production and oral depositions under oath of fact and expert witnesses. Counsel for the company and its directors could object to any discovery on grounds of privilege, relevance, or burden, and could also take discovery from the relator's witnesses. The judge would have discretion to limit discovery or to direct that discovery be provided even if not demanded by the relator's counsel.

[43] In this respect, the petition could resemble securities fraud complaints brought under the Private Securities Litigation Reform Act. See, e.g., Geoffrey P. Miller, Pleading After Tellabs, 2009 Wis. L. Rev. 510; Robert G. Bone, Twombly, Pleading Rules, and the Regulation of Court Access, 94 Iowa L. Rev. 873 (2009); Jill E. Fisch, Cause for Concern: Causation and Federal Securities Fraud, 94 Iowa L. Rev. 811 (2009).

At any point in the process, counsel for the company or the directors could petition to terminate the inquiry on the grounds that the allegations have been shown to be unsubstantiated or that further inquiry would harm the company. The relator's counsel could object to such a petition. The judge would have discretion to grant or reject the petition in whole or in part. The judge could also determine to terminate or limit the inquiry *sua sponte*.

This process would not be a lawsuit. For this reason the parties would not have the power to settle the matter privately. The parties could jointly petition to terminate or limit the inquiry, and the judge would give those requests considerable weight. However, the decision about whether to continue the inquiry, and on what terms, would be for the judge alone.

At the conclusion of discovery, or at any time during that process, the judge would convene a hearing to consider arguments and evidence. The judge would ordinarily conduct the proceeding on the model of a trial. However, the judge could in his or her discretion depart from trial-type procedures and conduct the hearing in a different way. The hearing would ordinarily be public; but the judge could, if he or she deems it appropriate, conduct all or some of the discussion on a confidential basis.

At the conclusion of the hearing, the judge would solicit summaries and arguments from counsel and then compose a report. The report would not assess liability and would not reach legal conclusions. Rather it would set forth findings of fact and express the judge's views about the board's decision processes. The report would ordinarily be made public in its entirety, although the judge would have discretion to redact portions in the interest of confidentiality or the protection of privacy. Information obtained during the investigation could be used in subsequent litigation subject to ordinary rules of evidence. The relator would be entitled to petition the judge for a reasonable attorneys' fee payable from the company's treasury, based on the therapeutic value (if any) of the services rendered.

2. Pros and Cons

I now turn to an analysis of pros and cons of the judicial inquiry idea, looking first to issues of capacity – would it be appropriate for Chancery Court judges to conduct judicial inquiries? – and then at issues of effectiveness – would judicial inquiries hold the potential to improve the performance of Delaware corporations?

a. Capacity

1. It is no objection to the judicial inquiry proposal to say that it imposes a non-judicial function on the Chancery Court. It is true that Delaware courts resist efforts to involve them in procedures outside of ordinary litigation.[44] But the judges involved in a judicial inquiry would not be acting in a judicial capacity. Constitutional or prudential limits on the activities of judge when acting in a judicial capacity would not apply to their actions as conveners of judicial inquiries.

2. Moreover, it is not clear that a judicial inquiry would be outside the power of the Delaware courts *qua* courts. The Delaware Supreme Court has long had the power to issue advisory opinions on questions of constitutional law,[45] and since 2007 has also been

[44] For example, Delaware judges will not issue advisory opinions to private litigants, Rollins Int'l, Inc. v. Int'l Hydronics Corp., 303 A.2d 660, 662 (Del.1973), even when the matter is one of fiduciary duty, Energy Partners, Ltd. v. Stone Energy Corp., 2006 WL 2947483, at *7 (Del. Ch. Oct. 11, 2006). They insist that litigants have standing in the sense of a genuine stake in the controversy, O'Neill v. Town of Middletown, 2006 WL 205071 (Del. Ch. Jan. 18, 2006), and recognize the dangers of collusive litigation and the value of measures designed to prevent this form of abuse, McHugh v. Brown, 125 A.2d 583, 588 (Del. 1956) (deterring collusive litigation is "a specific and important legislative policy").

[45] 10 Del.C. § 141. The request for an advisory opinion must come from the governor or either house of the legislature.

empowered to answer questions of law certified to it by other Delaware courts, the Supreme Court of the United States, a Court of Appeals of the United States, a United States District Court, the United States Securities and Exchange Commission, or the highest appellate court of any other state.[46]

If advisory opinions are constitutionally permissible in Delaware, judicial inquiries would probably also be permissible. The process contemplated by the judicial inquiry idea is closer to a traditional judicial procedure than an advisory opinion. The matter in question is neither hypothetical nor abstract. Nor would the process be collusive or lacking in adversarial presentation. On the contrary, the relator's counsel would be expected to claim that the directors employed defective processes in reaching their decision; the directors' counsel (usually supported by the company itself) would be expected to present a defense. In many respects the judicial inquiry proposed here would resemble ordinary shareholders derivative litigation – matters well within the jurisdictional competence of the Delaware courts.

3. This leaves open the question whether the Delaware legislature would have the power to create new, non-judicial responsibilities for the judges of the Chancery Court. This is a question of separation of powers under Delaware law. Although the issue is unresolved, there are reasons to think that the creation of such responsibilities would be within the power of the Delaware legislature. The proposed process, while not formally a procedure conducted by a court, nevertheless has a close resemblance to a judicial proceeding. The judges of the Delaware courts would not be asked to do anything outside the ordinary scope of their activities. The only obligation placed on the Delaware

[46] 4 Del.C. § 11(8). The Delaware Supreme Court has already issued a major opinion under this authority. See CA, Inc. v. AFSCME Employees Pension Plan, 953 A.2d 227 (Del.Supr. 2008).

judges, moreover, would be to review petitions for the commencement of an inquiry; what to *do* about those petitions would be entirely within their discretion. Finally, judicial inquiries are not unprecedented; similar procedures have been used in the United States and other common law countries without constitutional difficulties.[47]

4. Judicial inquiries would not represent an unreasonable burden on the judiciary. Such inquiries might be time-consuming once commenced, but there probably would not be many of them. In the unlikely event that judicial inquiries began to swamp out ordinary judicial business, the legislature could always authorize the appointment of new judges.

5. The judicial inquiry would not be a distraction from the courts' core responsibility. Instead, it would represent an alternative and potentially more efficacious means for carrying out the task of enforcing compliance by directors with their fiduciary duties.

6. A judge's involvement in a judicial inquiry would not interfere with his or her ability to handle subsequent litigation involving the same allegations, facts, or parties. This is not a situation where a judge takes on a non-judicial responsibility that might compromise independence -- as might be the case, for example, if the judge took temporary service as a prosecutor and then ruled, as judge, on some matter growing out

[47] The most famous American investigation of all, the Warren Commission, was chaired by the sitting Chief Justice of the United States. See Report of the President's Commission on the Assassination of President John F. Kennedy (1964). Some American states support investigatory commissions chaired by or including members of the state's judiciary. See, e.g., http://www.courts.state.va.us/agencies/jirc/about.html (Web Site of Virginia Judicial Inquiry and Review Commission, a 7-member body, including three judges, which is charged with investigating charges of judicial misconduct or disability in that state). The United Kingdom makes extensive use of judicial inquiries, not only to investigate controversial events but even to analyze basic questions of public policy. See Robert Stevens, The Independence of the Judiciary: The Case of England, 72 S. Cal. L. Rev. 597, 604-07 (1999). A similar procedure, the commission of inquiry, is used in Israel. See Zeev Segal, The Power to Probe Into Matters of Vital Public Importance, 58 Tul. L. Rev. 941, 961 (1984).

of the prosecution.[48] The judge's exposure to the facts and circumstances in a judicial inquiry would occur in a trial-like setting, with adversarial representation, and subject to reasonable rules regarding the admission and review of evidence. Thus there should be little difficulty for a judge to sit on a case involving the same transaction that was in issue in a judicial inquiry. If such difficulty did present itself – if the judge considered that her involvement was of such a nature as to comprise independence or create the appearance of partiality – the judge could always recuse herself from any litigation involving the same facts and circumstances as those involved in the inquiry.

b. Effectiveness

1. The lack of a legal remedy does not make the judicial inquiry less effective than derivative litigation, since legal remedies are not available as a practical matter in duty of care cases in any event.[49] Moreover, the judicial inquiry idea is not a substitute for the derivative remedy but merely a supplement. Derivative litigation could still be brought.

2. Judicial inquiries could offer a valuable means for developing and articulating norms or best practices for corporate directors. Because, unlike the derivative lawsuit, judicial inquiries would not be tied to a finding of liability, the judge conducting such an inquiry would have greater scope than under current law for investigating pertinent matters and crafting a report in which the articulation of norms or best practices is dealt with in a straightforward fashion.

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[48] As Justice Jackson did when he assumed the duties of chief prosecutor at Nuremburg while remaining a member in good standing of the United States Supreme Court. See Maeva Marcus, Is the Supreme Court a Political Institution?, 72 George Washington Law Review 95, 98 n.17 (2003).

[49] See notes __-__ and accompanying text supra.

3. Because judicial inquiries do not require a favorable judgment (or settlement) as the basis for the award of attorneys' fees, they offer incentives for plaintiffs' attorneys to bring duty of care claims to the attention of the courts – in contrast to derivative litigation where such incentives are virtually absent. Judicial inquiries, moreover, would not be pre-empted by a settlement in which the defendant admits no liability. Liability is not an issue in a judicial inquiry, and the judge would have the capacity to issue a report even if both parties requested that the inquiry be terminated.

4. Judicial inquiries offer a stronger basis for the judge to make normative evaluations of the procedures employed by directors: these would be what the judge is *supposed* to do. A judge conducting a judicial inquiry could engage in a more direct, forthright and substantive review of managerial decision processes than is possible in a shareholders derivative lawsuit.

5. The judicial inquiry would encourage judges to make positive as well as negative judgments. Unlike derivative litigation, where the focus is relentlessly on the negative because the judge is asked to consider whether directors engaged in misconduct, the judicial inquiry would be more open-ended. Judges could look into all aspects of a decision. If some directors behaved exceptionally well, as opposed to exceptionally badly, the report could administer appropriate praise. The possibility of positive rewards for good behavior could encourage diligent management and help stiffen the spines of directors who are doubtful about the decisions being taken by their peers.

6. Unlike derivative litigation, judicial inquiries would not carry a mixed message. Because no liability is contemplated, the sanction is delivered in pure form with no subtext of approval undermining its force.

7. Judicial inquiries could contribute to greater disclosure and openness in the management of public companies, since the judge conducting the inquiry would have the power to examine the company's decision processes and would be expected to issue a public report of his findings. The improved transparency could reduce public suspicion of the motivations or actions of corporate directors and also enhance the role of shareholders in governance by providing them with more information about the activities and policies of the firms in which they have invested.[50]

8. Judicial inquiries are unlikely to deter directors from undertaking reasonable risks. The inquiry, as I envisage it, would be limited to the issues cognizable under the Business Judgment Rule – whether the board adequately informed itself of the facts and engaged in proper and sufficient deliberations. Moreover, because Chancery Court judges are sensitive to the need to allow room for entrepreneurial risk-taking,[51] reports of judicial inquiries would be unlikely to fault directors for approving a project that appeared to be a good risk ex ante even if the outcome was bad ex post. More likely, they would praise rather than blame directors brave enough to take on risky but beneficial projects.

9. Judicial inquires would not threaten the ability of Delaware corporations to recruit good people to serve on corporate boards. Such inquiries would be quite rare and would by definition impose no threat of liability. Moreover, if judicial inquiries

[50] See, e.g., Lucian Arye Bebchuk, The Case for Increasing Shareholder Power, 118 Harv. L. Rev. 833, 875 (2005) (recommending devices to enhance shareholder power); Jill E. Fisch, Measuring Efficiency in Corporate Law: The Role of Shareholder Primacy, 31 J. Corp. L. 637, 662-63 (2006) (relating fiduciary duties to shareholder accountability). On the other hand, the possibility of greater disclosure could have a chilling effect on boardroom deliberations on sensitive matters. To address this concern, the judge conducting the inquiry should have discretion in appropriate cases to limit discovery or to redact parts of the report which is given to the public.

[51] See E. Norman Veasey & Christine T. Di Guglielmo, What Happened in Delaware Corporate Law and Governance from 1992-2004? A Retrospective on Some Key Developments, 153 U. Pa. L. Rev. 1399, 1421-1428 (2005).

contributed to the perception that Delaware was seriously monitoring corporate managers, the presence of such a remedy could increase the prestige of serving on the board of a Delaware corporation, potentially increasing rather than decreasing the attractiveness of such a position.

10. Fees awarded in judicial inquiries would likely be more substantial than those currently allowed in corporate cases generating only therapeutic relief. The reason is that in a standard derivative case the courts are likely to view therapeutic relief as worth very little in comparison with what the plaintiff sought in the litigation, and thus will be inclined to impose a significant haircut on the fee request. In a judicial inquiry, on the other hand, there is no expectation that the relator will obtain any relief at all. The court can therefore feel comfortable in awarding a fee based on the quality of the relator's work. If a relator has survived the threshold screen by providing the court with plausible allegations of gross negligence, she can have some degree of confidence that a reasonable effort to support those claims in the ensuring judicial inquiry will be rewarded with a suitably compensatory fee.

IV. Conclusion

This paper has offered a modest proposal for fixing Delaware's broken duty of care: enhance the ability of Chancery Court judges to engage in commentary on the procedures used by the board in making important decisions. One means for upgrading the judicial commentary remedy is for judges to award attorneys' fees to unsuccessful plaintiffs whose efforts have exposed significant shortcomings in the decision-making process. Another option is the judicial inquiry into credible allegations of gross negligence. These reforms would be within the judicial capacity and could, at the margin, improve the management of Delaware firms.