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THE ELEPHANT IN THE ROOM: HELPING DELAWARE COURTS DEVELOP LAW TO END SYSTEMIC SHORT-TERM BIAS IN CORPORATE DECISION-MAKING

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Short-termism in corporate decision-making is as problematic for long-term investors as relying on a three-mile radar on a supertanker. It is totally inadequate for handling the long-term risks and opportunities faced by the modern corporation. Yet recent empirical research shows that up to 85% of the S&P 1500 have no long-term planning. This is costing pension funds and other long-term investors dearly. For instance, the small minority of companies that do long-term planning and risk management had a long-term profitability that was 81% higher than their peers during the 2001–2014 period—with less stock volatility that costs investors dearly as well. This

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corporate short-termism mindset is even more troubling given that at least half of the value of the companies in the S&P 1500 is generated by expectations for realization of future value. Long-term investors therefore face a long-term expectations pipeline of hoped-for returns without a plan by corporations to back it up. The tragic result: this short-termism mindset appears to have a substantial depressing impact on long-term market returns while increasing long-term risk exposure. Both have contributed to the significantly underfunded status of many pension funds today.

Delaware courts, the primary referees of corporate director fiduciary duties in the United States, are so frustrated with the persistent effects of short-term pressures—including corporate fraud and compliance breaches—that they are actively encouraging investors to bring the right cases to help change the rules. This Article examines the effects of short-termism and the Delaware judiciary's responses to it. It then shows how existing Delaware law could be extended to address the underlying causes of corporate short-term bias, rather than merely imposing punishment on the symptoms.

INTRODUCTION

Pension funds and other investors with long-term liabilities are at a watershed moment—facing both a life-threatening crisis and an unexpected opportunity to resolve their predicament through use of the Delaware courts.[2] Pervasive short-termism in corporate decision-making is the underlying elephant-in-the-room crisis.

Recent empirical research shows short-termism is a recipe for disaster for pension funds and other long-term institutional investors. Over half of the market value of the S&P 1500 is now future value.[3] Corporations with *long-term* planning have generated *81% more long-term profits* from 2001–2014 than other corporations without such planning—and with far less volatility.[4] Yet 85% of the S&P 1500 have no long-term strategic business plan longer than three to five years.[5] To the contrary, most directors myopically focus on quarterly returns—with all the accompanying risk and corner-cutting.[6] The amount of money lost by long-term investors is enormous, despite it being largely invisible to investors who exclusively use market-relative performance benchmarks. Corporate governance reform efforts by pension funds and other shareholders have

2. *See, e.g.*, Knowledge@Wharton, *Underfunded Pensions: Tackling an 'Invisible Crisis,'* WHARTON (Jan. 26, 2015), http://knowledge.wharton.upenn.edu/article/underfunded-pensions-tackling-an-invisible-crisis/ (noting that "Chicago's unfunded liabilities are 10 times its revenues."); *see also* David Crane, *California's $500-billion pension time bomb,* L.A. TIMES (Apr. 6, 2010), http://articles.latimes.com/2010/apr/06/opinion/la-oe-crane6-2010apr06 ("The state of California's real unfunded pension debt clocks in at more than $500 billion, nearly eight times greater than officially reported."); Darren Behar, *Fears of Pensions Timebomb*, DAILY MAIL, http://www.dailymail.co.uk/news/article-85707/Fears-pensions-timebomb.html (last visited Nov. 29, 2018).

3. Dominic Barton, James Manyika, & Sarah Keohane Williamson, *Finally, Evidence That Managing for the Long Term Pays Off*, HARV. BUS. REV. (February 9, 2017), https://hbr.org/2017/02/finally-proof-that-managing-for-the-long-term-pays-off ("New research . . . found that companies that operate with a true long-term mindset have consistently outperformed their industry peers since 2001 across almost every financial measure that matters.").

4. *Id.* ("From 2001 to 2014 those managing for the long term cumulatively increased their economic profit by 63% more than the other companies. By 2014 their annual economic profit was 81% larger than their peers, a tribute to superior capital allocation that led to fundamental value creation.").

5. *See* MARK VAN CLIEAF, STEPHAN O'BYRNE & KAREL LEEFLANG, THE ALIGNMENT GAP BETWEEN CREATING VALUE, PERFORMANCE MEASUREMENT, AND LONG-TERM INCENTIVE DESIGN (2014), https://irrcinstitute.org/wp-content/uploads/2015/09/alignment-gap-study1.pdf.

6. Alex Edmans, Vivian Fang & Allen Huang, *The Long-Term Consequences of Short-Term Incentives* 2 (Oct. 4, 2017) (unpublished working paper), https://irrcinstitute.org/wp-content/uploads/2017/12/13-Huang-Edmans-Fang-The-Long-Term-Consequences-of-Short-Term-Incentives.pdf ("The concern with short-term incentives is that they lead to the CEO taking myopic actions that boost the short-term stock price at the expense of long-run value."); *see also* DOMINIC BARTON, JONATHAN BAILEY & JOSHUA ZOFFER, RISING TO THE CHALLENGE OF SHORT-TERMISM (2015), https://www.fcltglobal.org/docs/default-source/default-document-library/fclt-global-rising-to-the-challenge.pdf.

made no serious dent in this short-termism problem. Given this factual landscape, it is no surprise that many pension funds are underfunded.[7]

However, there is an unexpected and powerful ally emerging to reverse this harmful trend: the Delaware courts. Indeed, the Delaware courts are seeking assistance from pension funds and other long-term investors in the battle. It is not often that courts actively seek help from the outside. Here is why they have broken that norm to combat this problem:

Delaware courts are the key architects that define the rules of the game for corporate decision-making. In that role, they are on the front lines dealing every day with the magnitude of corporate meltdowns and financial cataclysms of recent history. From that front-line perspective, it is obvious to Delaware courts that much of the corporate fraud and failure to comply with laws that triggers meltdowns are merely *symptoms* of short-termism.

As a result, Delaware courts are showing increased willingness to broaden the relevant director fiduciary duties that govern the process of corporate risk-assessment and decision-making. But the Delaware courts cannot bring these cases on their own. They need enlightened investors to seek an extension of Delaware law to coincide with what the United Kingdom and European Union have already done, *i.e.*, require directors to consider long-term consequences in decisions.[8] Delaware courts also offer another valuable reform tool for long-term investors—the Delaware books and records statute—to give leverage to current corporate governance reform efforts focused on corporate disclosure and cooperative shareholder engagement.[9]

This crisis, like Enron, Worldcom, Lehman Brothers, and the ever-increasing volume of calamities caused by unsustainable business models, is exaggerated by an economic culture incentivized to seek quick wins at the expense of long-term risks or long-term sustainable profits.[10] But these fraud-related collapses are often mere symptoms of the bigger problem of short-termism in corporate decision-making generally. Leo E. Strine, Jr., Chief Justice of the Delaware Supreme Court, has put the problem and the solution succinctly:

7. Michael Edesess, *The Reason Underfunded Pensions are a Disaster Waiting to Happen*, MARKETWATCH (Apr. 5, 2017, 2:25 PM), https://www.marketwatch.com/story/the-reason-underfunded-pensions-are-a-disaster-waiting-to-happen-2017-04-03; *see also* Thomas Born, *Nearly Half of Americans Will Retire Broke*, RT.COM (Mar. 17, 2018, 8:22 AM), https://www.rt.com/business/421569-crisis-us-half-retire-broke/.

8. *See, e.g.*, The UK Companies Act (2006) §172(1) (requiring directors to have regard for "the likely consequences of any decision in the long term.").

9. *See* Tom McParland, *Chancery Court Opens Health Care Company's Documents to Investors,* DEL. BUS. CT. INSIDER (Mar. 1, 2018, 5:17 PM), https://www.law.com/delbizcourt/2018/03/01/chancery-court-opens-health-care-companys-documents-to-investors/?kw=Chancery%20Court%20Opens%20Health%20Care%20Company%27s%20Documents%20to%20Investor.

10. *See* Malcolm Salter, *How Short-Termism Invites Corruption . . .And What to Do About It*, HARV. BUS. SCH. (Apr. 2012), http://www.hbs.edu/faculty/Publication%20Files/12-094_8260785f-0417-45d1-8abc-0afe86f87eaa.pdf.

> [T]o foster sustainable economic growth, stockholders themselves must act like genuine investors, who are interested in the creation and preservation of long-term wealth, not short-term movements in stock price.[11]

Our thesis is that the Delaware courts—frustrated by this trend of short-termism—have been laying the legal groundwork to adapt corporate jurisprudence—and particularly the Business Judgment Rule ("BJR")—to include long-term strategic risk planning processes. The legal devices necessary to obtain evidence substantiating such claims already exist.[12] Delaware jurists have signaled their willingness to explore this pathway of responsible corporate planning. Furthermore, long-term planning is a goal that public policy should encourage, in light of recent legal[13] and economic history.[14] Finally, the ideal plaintiff has awakened: pension-funds and similar institutional investors. As stewards of assets invested to cover longstanding obligations, these institutional investors owe fiduciary duties with the most literal requirements for long-term planning.[15] This uniquely situates them to drive Delaware fiduciary duty law in a direction that emphasizes a focus on long-term corporate well-being.

In this Article, we chart a path through the law, demonstrating how the BJR has evolved and narrowed in exculpatory scope over time. We highlight recent cases and prominent jurists that are explicit in their support of long-term strategic planning as a core corporate goal. We chart out a new framework that includes a process requirement for long-term risk evaluation. We suggest that the time is right for a test case to push this theory.

Finally, we identify the ideal plaintiffs for such a test case that have the strongest incentive to evolve the law: pension funds, sovereign wealth funds, foundations, and similar asset owners—institutional entities with litigation power that are organized for the purpose of long-term and sustainable wealth creation. These institutional stewards of long-term funds have an obligation to provide profits for hundreds of years and the power to influence corporate directors to consider long-term risks and profitability.

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11. Leo E. Strine, Jr., *One Fundamental Corporate Governance Question We Face: Can Corporations Be Managed for the Long Term Unless Their Powerful Electorates Also Act and Think Long Term?* 66 BUS. LAW. 1, 26 (2010).

12. McParland, *supra* note 9.

13. Leo E. Strine, Jr., *Corporate Power Ratchet: The Courts' Role in Eroding 'We the People's' Ability to Constrain Our Corporate Creations*, 51 HARV. C.R.-C.L. L. REV. 423, 437 (2016) (describing how the Supreme Court's decision in Citizens United v. Fed. Election Comm'n, 558 U.S. 310 (2010), augmented corporate power to influence society through political lobbying and mass media).

14. *See, e.g., The 2008 Financial Crisis: How It All Began,* WALL ST. J. (Aug. 17, 2017, 3:17 PM), https://www.wsj.com/articles/the-2008-financial-crisis-how-it-all-began-1502997466.

15. DAVID WEBBER, THE RISE OF THE WORKING-CLASS SHAREHOLDER: LABOR'S LAST BEST WEAPON (2018).

I. THE IMBALANCE BETWEEN LONG-TERM INVESTOR GOALS AND SHORT-TERMISM IN CORPORATE DECISION-MAKING

Just a few simple facts highlight how far out of balance—and intractable—the situation has become. Corporations that engaged in long-term planning had profits 81% higher between 2001 and 2014—with less volatility—than other firms.[16] Because pension funds and other institutional investors control about 70% of the U.S. equities market, market pressures alone should therefore encourage long-term strategic planning.[17]

Yet the opposite is happening in the overall corporate marketplace. At least 50% of the current value of the top 1500 S&P corporations is future value. And the trend toward future value as a higher percentage of total equity value is growing.[18] As future value has increased (often to 20 times earnings or more), a huge disconnect has developed in companies where there is no strategic assessment of long-term profitability. Eighty-five percent of these corporations have no strategic planning horizon longer than 5 years.[19] Seventy-five percent of them have no long-term measures of capital efficiency.[20] Eighty-five percent have no disclosed future value metrics—like amount of innovation and research and development ("R&D").[21] Eighty-five percent have long-term incentive plan performance periods of less than 3 years.[22] Finally—and astoundingly—only 100 of the top S&P 1500 companies do any significant R&D, which is key to long-term value maximization in today's world.[23]

To make matters even worse, this problem operates within a black box system. The long-term assessment process is not merely flawed; there is also little disclosure. The result is that institutional investors—and pension funds in particular—cannot effectively monitor and evaluate how a company will manage its large component of future value or the extent to which that future value component may realistically be a sham.

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16. *See* Barton et. al., *supra* note 3.

17. *Id.*

18. *See* VAN CLIEAF ET. AL., *supra* note 5, at 10.

19. *See* Dominic Barton et. al., *Where Companies with a Long-Term View Outperform Their Peers,* MCKINSEY GLOBAL INST. (Feb. 2017), https://www.mckinsey.com/global-themes/long-term-capitalism/where-companies-with-a-long-term-view-outperform-their-peers ("Recent surveys of C-suite executives that we have conducted suggest that pressure to deliver strong short-term results has increased in the past five years and, as a result, many executives believe their companies are using excessively short time horizons in their strategic planning.").

20. Heather Kerr & Hannah Dumas, *Executive Incentive Plans: How Leading Companies Pay for Performance*, EQUILAR (Apr. 6, 2016), http://www.equilar.com/reports/35-executive-incentive-plans.html.

21. *See* VAN CLIEAF ET. AL., *supra* note 5, at 61.

22. *Id.* at 65.

23. *Id.*

This is not merely an abstract or academic problem. Pension funds and their delegated fiduciary agents owe strong legal duties to millions of workers.[24] As with the corporations themselves, these fiduciaries are making vital investment decisions with other people's money. The ultimate fund beneficiaries must have a long-term investment horizon to protect their retirement or meet their other long-term savings goals.[25] But that is far too often not happening with their fund investments at the corporate level. Corporate reform efforts by institutional investors are not yet making a serious dent in these stark realities of short-termism.

II. THE EVOLUTION OF DELAWARE BREACH OF FIDUCIARY LAW AND THE BUSINESS JUDGMENT RULE IN RESPONSE TO FRUSTRATION OVER SHORT-TERMISM

It is not just enlightened long-term investors that are frustrated with short-termism in corporate decision-making. Delaware courts—the referees of the rules of the game for corporate director fiduciary duties—are frustrated as well and have expressed, on multiple occasions, a willingness to do something about it. And they are asking for help from long-term investors like pension funds to do it.

A. *The Delaware Courts' Frustration with Short-Termism and Its Request for Help from Long-Term Investors*

Amongst the leaders of change is none other than Delaware Chief Justice Leo Strine, Jr., a distinguished, internationally recognized legal scholar and judge. To understand the Delaware Supreme Court's frustration, one need look no further than to a number of his speeches and articles.

In July 2005, before becoming Chief Justice Strine, gave a speech to the European Policy Forum in London, stating: "[M]ost of us think the market's fetishistic preoccupation with quarter-to-quarter profits is stupid. Anyone who is

24. *See, e.g.,* T. Leigh Anenson, *Public Pensions and Fiduciary Law: A View from Equity*, 50 U. MICH. J.L. REFORM 251, 254 (2017) ("All states recognize that pension assets are held in trust and that managers are fiduciaries.").

25. *See* Larry Fink, *Annual Letter to CEOs: A Sense of Purpose*, BLACKROCK (Jan. 16, 2018), https://www.blackrock.com/corporate/investor-relations/larry-fink-ceo-letter ("Without a sense of purpose, no company, either public or private, can achieve its full potential. It will ultimately lose the license to operate from key stakeholders. It will succumb to short-term pressures to distribute earnings, and, in the process, sacrifice investments in employee development, innovation, and capital expenditures that are necessary for long-term growth. It will remain exposed to activist campaigns that articulate a clearer goal, even if that goal serves only the shortest and narrowest of objectives. And ultimately, that company will provide subpar returns to the investors who depend on it to finance their retirement, home purchases, or higher education.").

honest will admit that this obsessional behavior contributed to wrongdoing at corporations like Enron and Health South."[26]

Then, in 2010, Strine wrote a seminal article in THE BUSINESS LAWYER, stating that corporations exist to build long-term "durable wealth"—not short-term profits: "To build wealth in a durable manner, corporations need to commit capital to long-term endeavors, often involving a lag time between the investment of capital and the achievement of profit, a long time during which activities like research and development occur."[27] In that same article, Strine went further to state a virtual mantra adopted by many pension funds and long-term investors—*corporations are here to generate "societal wealth"*:

> The hoped-for outcome of this [corporate] risk taking, in the aggregate, is an increase in societal wealth, and not simply through the generation of profits. Rather, to generate profits, corporations have an incentive to employ workers and develop innovative products and services, and to engage in other activities that increase societal wealth.[28]

Strine ended by *chastising* long-term investors like pension funds for not pressing corporations harder to achieve "sustainable wealth":

> In sum, real investors want what we as a society want and we as end-user, individual investors want, which is for corporations to create *sustainable wealth*. Until, however, the institutions who control and churn American stocks actually act and think like investors themselves, it is unrealistic to think that the corporations they influence will be well-positioned to advance that widely shared objective . . . . *to foster sustainable economic growth*, stockholders themselves must act like genuine investors, who are interested in the creation and preservation of long-term wealth, not short-term movements in stock price.[29]

It is rare that a Court seeks help from a party to help solve a problem—it is usually the other way around. That is a "man-bites-dog" story. That is real news that should not be ignored by pension funds and other long-term investors.

B. *Delaware Courts' Strong Backing of Long-Term Value Maximization as a Key Corporate Goal*

Delaware courts are increasingly backing up their strong words with judicial opinions and language aimed at shifting the balance back towards long-term goals and strategy in corporate decision-making. Delaware courts have long stressed that the clear, unequivocal goal of a director's fiduciary duty to shareholders is to act in the "best interest" of shareholders.[30] To that end, Delaware

26. *See* Stephen Taub, *Influential Delaware Judge Slams Sarbox*, CFO (Jul. 6, 2005), http://www.cfo.com/article.cfm/4149256.

27. Strine, *supra* note 13, at 3.

28. *Id.* at 2.

29. *Id.* at 26 (emphasis added).

30. Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) ("It is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.") (citations omitted).

[common law] literally built a "best interest" goal into the very definition of a corporate director's fiduciary duty.[31] That "best interest" goal is also built into the very definition of Delaware's BJR presumption.[32]

Further, Delaware courts have increasingly stressed *long-term* strategic planning as part of that "best interest" goal since at least 1986—and with growing frequency over the past several years after the fallout of Enron and the global financial crisis.[33] In just the past five years, Delaware courts have published opinions emphasizing long-term strategy with the following quotes: Directors must "maximize the value of the corporation over the long term."[34] Directors must "maximize [the corporation's] value over the long-term for the benefit of its shareholders."[35] Directors must "maximize the value of the corporation over the long-term for the benefit of the providers of equity capital."[36]

Therefore, it is reasonable to conclude that the "best interest" goal includes an obligation to maximize the value of the corporation over the long-term rather than the short term. Indeed, as a corollary, Justice Strine is explicit that directors are *not* required to maximize short-term profits at the expense of long-term

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31. *See id.*

32. *See id.*

33. *See generally* Katz v. Oak Indus. Inc., 508 A.2d 873, 879 (Del. Ch. 1986) ("It is the obligation of directors to attempt, within the law, *to maximize the long-run interests of the corporation's stockholders*; that they may sometimes do so 'at the expense' of others (even assuming that a transaction which one may refuse to enter into can meaningfully be said to be at his expense) does not for that reason constitute a breach of duty.") (emphasis added) (footnote omitted).

34. Frederick Hsu Living Tr. v. ODN Holding Corp., No. 12108-VCL, 2017 WL 1437308, at *18–19 (Del. Ch. Apr. 14, 2017), *as corrected* (Apr. 24, 2017) ("In terms of the standard of conduct, therefore, the fiduciary relationship requires that the directors act prudently, loyally, and in good faith *to maximize the value of the corporation over the long-term* for the benefit of the providers of presumptively permanent equity capital, as warranted for an entity with a presumptively perpetual life in which the residual claimants have locked in their investment. . . . The fact that some holders of shares might be market participants who are eager to sell and would prefer a higher near-term market price likewise *does not alter the presumptively long-term fiduciary focus.*") (emphasis added). Although the case involved a unique and complex set of facts, a breach of the duty of disclosure was found in a corporate sale where it was not disclosed to shareholders that the company's valuation under its existing five-year plan yielded a higher value than the sale. *In re* PLX Tech., Inc. S'holders Litig., Consl. C.A. No. 9880-VCL, 2018 WL 5018535, at *101–02 (Del. Ch. Oct. 16, 2018) (The Court found a breach of fiduciary duty where the company was sold under pressure from a private equity investor to provide current returns when the board had a viable plan in place to generate more value over the long term by remaining independent. The Court noted: "particular types of investors may espouse short-term investment strategies and structure their affairs to benefit economically from those [short-term] strategies, thereby creating a divergent interest in pursuing short-term performance at the expense of long-term wealth.").

35. *In re* Rural Metro Corp., 88 A.3d 54, 80 (Del. Ch. 2014), *aff'd sub nom.* RBC Capital Mkts., LLC v. Jervis, 129 A.3d 816 (Del. 2015) ("More concretely, the fiduciary relationship between the Board and Rural's stockholders required that the directors act prudently, loyally, and in good faith to maximize Rural's value over the long-term for the benefit of its stockholders.").

36. *In re* Trados Inc. S'holder Litig., 73 A.3d 17, 37 (Del. Ch. 2013) ("In terms of the standard of conduct, the duty of loyalty therefore mandates that directors maximize the value of the corporation over the long-term for the benefit of the providers of equity capital, as warranted for an entity with perpetual life in which the residual claimants have locked in their investment.").

planning[37] and further can even prioritize the long-term interests of shareholders over short-term interests of bondholders.[38] But there is no common law that clearly establishes the opposite. That is, there is no clear Delaware authority condoning a corporate director that destroys the long-term future of a company for short-term profit. Rather the opposite—the most prominent examples of such trade-offs have historically been failures like the mortgage-backed securities crisis.[39] All of the foregoing establishes that corporate directors owe shareholders a fiduciary duty to build long-term value. Such a maxim logically requires *some* systematic strategic assessment of the long-term benefits and risks—as part of a decision-making process based on reasonably adequate information. Without some reasonable process by which to evaluate long-term risk, it is impossible for corporate directors to satisfy their fiduciary obligation to build long-term wealth.

C. *Delaware's Business Judgment Rule as an Offsetting Obstacle to Director Liability for Short-term Bias in Corporate Decision-Making*

So why, if Delaware courts solidly back "maximizing value of the corporation over the long-term" as the goal of corporate decision-making, has it not put a quick end to the short-termism reflected in what appears to be 85% of the S&P 1500, for example?

There are two reasonable explanations. First, court-made law, in common law and equity, typically progresses on a case-by-case basis. As former Chief Justice Veasy of the Delaware Supreme Court has stated, judges are like "clams."[40] They must wait for a case to be brought to them. Second is the Delaware BJR, which was framed a century ago in the 1930s with the heavy hand of New York City corporate lawyers protecting their corporate clients as much as possible from liability for corporate decisions.[41]

The BJR creates a presumption that corporate officers and directors "acted on an informed basis, in good faith and in the honest belief that the action taken

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37. Leo E. Strine, Jr., *Our Continuing Struggle with the Idea That For-Profit Corporations Seek Profit*, 47 WAKE FOREST L. REV. 135, 155 (2012) ("By so stating, I do not mean to imply that the corporate law requires directors to maximize short-term profits for stockholders.").

38. *See* Katz, 508 A.2d at 879.

39. *See generally* MICHAEL LEWIS, THE BIG SHORT: INSIDE THE DOOMSDAY MACHINE (2010).

40. E. Norman Veasey & Michael P. Dooley, *The Role of Corporate Litigation in the Twenty-First Century*, 25 DEL. J. CORP. L. 131, 133 (2000) ("We take the cases as they come to us. The courts sit like clams in the water waiting for whatever is brought by the tides. We don't give advisory opinions. We don't reach out to pluck the interesting issues of the day to make a ruling. We wait for our jurisdiction to be invoked.").

41. *See generally* Lyman Johnson, *Unsettledness in Delaware Corporate Law: Business Judgment Rule, Corporate Purpose*, 38 DEL. J. CORP. L. 405, 410 (2013) (tracing the history of the business judgment rule in Delaware).

was in the best interests of the company [and its shareholders]."[42] In the abstract, the BJR is meant to provide an offsetting "weight" in the balance against just automatically imposing liability on a director for a bad corporate decision that results in losses—long-term or short-term—after the fact.

On the one hand, Delaware courts have imposed a fiduciary duty of care and loyalty upon corporate directors to ensure there is a process of *informed choice* in corporate decision-making. After all, directors are the representatives of the shareholders in a corporation—and in that sense are like trustees of other people's money. A cornerstone of that fiduciary duty is that a director's decisions involving other people's money should be made only after a reasonable and rational process of information gathering and assessment. It should not be riverboat gambling.

On the other hand, corporate directors are more than just trustees that invest money; they are entrepreneurs who act on behalf of shareholders and take risks. Given this reality, a rigid trustee fiduciary duty obligation did not fit directors. Indeed, Delaware courts have been emphatic that courts are not in a good position to second-guess the risk-taking decisions of directors in hindsight.[43] It would also discourage directors from serving on corporate boards if they faced second-guessing by courts of risky decisions that turned out poorly.

As a result, the Delaware courts have made the focus of a director's fiduciary duties of care and loyalty the adequacy of the *process of decision-making rather than the decision itself*. The process is the *means* of achieving a good decision. In turn, the director's duty of care and duty of loyalty as fiduciary obligations are the *means* to insure a good *process* of decision-making—to achieve the end or goal of "the best interest" of shareholders, which presumptively includes long-term value maximization.[44]

That focus on *process* is consistent with risk-assessment principles in tort law.[45] A party that takes reasonable steps to assess risks before making an in-

42. *In re* Walt Disney Co. Derivative Litig., 907 A.2d 693, 746–47 (Del. Ch. 2005), (citing Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) ("The business judgment rule is not actually a substantive rule of law, but instead it is a presumption that 'in making a business decision the directors of a corporation acted on an informed basis, . . . and in the honest belief that the action taken was in the best interests of the company [and its shareholders].' ")).

43. *In re* Goldman Sachs Grp., Inc. S'holder Litig., Civil Action No. 5215-VCG, 2011 WL 4826104, at *1 (Del. Ch. Oct. 12, 2011) ("So long as [directors] act within the boundaries of their fiduciary duties, judges are ill-suited by training (and should be disinclined by temperament) to secondguess [sic] the business decisions of those chosen by the stockholders to fulfill precisely that function.").

44. Frederick Hsu Living Tr. v. ODN Holding Corp., No. CV 12108-VCL, 2017 WL 1437308, at *19 (Del. Ch. Apr. 14, 2017), *as corrected* (Apr. 24, 2017) (explaining that the presumptively long-term fiduciary focus does not require directors to appease a small subset of the shareholder base).

45. *See*, *e.g.*, 6 STUART SPEISER ET AL, AMERICAN LAW OF TORTS § 18:90 (Monique C.M. Leahy ed., 2018) ("Its duty, as the cases indicate, is to take reasonable steps within the limitations of cost, technology, and marketability to design and produce a product . . . that will minimize the unavoidable danger."); *see also* Robert J. Rhee, *The Tort Foundation of Duty of Care and Business Judgment*, 88 NOTRE DAME L. REV. 1139, 1143 (2013) ("Under a correct account of the tort analo-

formed judgment on appropriate safety steps is generally inoculated from liability if an unforeseen injury occur later.[46] By the same token, a director will not be held liable if the process of reviewing and assessing both the key benefits and risks was reasonable to achieve the goal, even if the decision ended up being wrong and costly.

But historically, the Delaware courts have gone *two steps further* than just imposing a reasonableness-of-process standard to restrict liability on directors. First, the BJR states a presumption. Absent fraud or conflict of interest, a director is *presumed* to act in good faith in the best interest of shareholders. The burden shifts to the plaintiff-shareholder to overcome that presumption, and it is typically a tough burden indeed.[47]

Second, there is a demanding burden to actually prove the breach of a fiduciary duty. Delaware courts only allow liability for breach of a duty of care by a gross negligence standard and require an even higher "conscious disregard" ("bad faith") standard to prove a breach of the duty of loyalty (which is discussed below).[48]

For Delaware courts to bend over this far backwards, however, creates a potential problem where long-term consequences should be considered. Directors may interpret the best way to take advantage of BJR protection is to game the system by cleverly ignoring or not wanting to analyze long-term consequences. Indeed, directors may think that such a "see no evil, hear no evil" going-through-the-motions approach to the decision-making process is better than the alternative of proactive searching for information on long-term consequences. That perception could only reinforce short-termism bias. Such a result would be tragic because it would eviscerate Delaware courts' express holdings that the goal of the director's duty of loyalty and care should be a maximization of corporate value *over the long term* for shareholders.

gy, the duty of care and the business judgment rule are not antipodes of a paradox, but are complementary principles governing duty and its scope.").

46. *Id.*

47. Lyman P.Q. Johnson, *Corporate Officers and the Business Judgment Rule*, 60 BUS. LAW. 439, 454–55 (2005) ("From this simple statement—and later case law elaboration—several undisputed points about the Delaware rule emerge. The rule applies to directors; the rule applies to directors when they act collectively, that is, as a board or as a committee of the board; the rule applies only to considered director judgments, not to unconsidered inaction; directors must be independent and disinterested as to the matter acted upon; directors must act with due care and in good faith; the due care inquiry is process-oriented and due care is measured by a standard of gross negligence, not simple negligence; the burden of proof is on the party challenging the board's decision to establish facts rebutting the presumption in favor of upholding the decision. Unless a plaintiff succeeds in rebutting the rule, the court will not substitute its views for those of the board's if the latter's decision can be 'attributed to any rational business purpose.' ") (citations omitted).

48. *See In re* Walt Disney Co. Derivative Litig., 906 A.2d 27 (Del. 2006).

D. *Options for Expanding Directors' Fiduciary Liability for Failing to Undertake Long-Term Strategy Planning and Assessment*

Based on the above, there is a clear need for Delaware courts to deal with the "elephant in the room." The extreme short-termism of current corporate decision-making essentially creates an incentive for fraud. Indeed, Enron and other meltdowns show that fraud is primarily driven by the outgrowth of pressures for short-term profitability at the expense of the long-term.[49]

However, the core question is much bigger than just intentional fraud. Long-term risk is a core component of business strategy for a going concern. The world is changing: finite resources, toxic waste, and many outside forces will dramatically reshape risk for almost every corporation on the planet.[50] New technologies, evolving consumer behaviors, and a shifting population are also long-term risks that corporations cannot ignore.[51] In a world where long-term risks—and enhanced profitability from research and development—are so important, such assessment cannot be swept under the table. That is like limiting the radar on a supertanker to three miles or less—not looking further out. No matter how well intentioned the directors, the decisions will likely be bad for the shareholders in the long-term where it counts. Kicking the long-term can down the road by constantly grabbing for short-term results is not a viable solution. Meanwhile, other jurisdictions around the world have opted not to procrastinate and have already amended their corporate laws to require long-term strategic planning in some form.

For instance, in the United Kingdom there is now *an express inclusion* of the duty of a director to consider "long-term consequences of decisions" as part of acting in a way that benefits shareholders as a whole.[52] The UK Companies Act 2006 states in Section 172 that consideration of long-term consequences is one of the requirements the act has "codified [from] the common law and equitable duties of directors."[53]

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49. *See, e.g.*, Salter, *supra* note 10.

50. *See Climate Change and Resource Scarcity*, MEGA TRENDS (PricewaterhouseCoopers, London, U.K.), https://www.pwc.co.uk/issues/megatrends/climate-change-and-resource-scarcity.html (last visited Nov. 29, 2018).

51. Rob Griffin, William H. Frey, Ruy Teixeira, *States of Change: Demographic Shifts, Representation Gaps, and America's Future,* BROOKINGS (Mar. 1, 2017), https://www.brookings.edu/research/states-of-change/. *How Will Changing Demographics in the U.S. Influence Business in the Coming Decade?*, WALL ST. J. (Nov. 29, 2013, 3:34 PM), https://www.wsj.com/articles/how-will-changing-demographics-in-the-us-influence-business-in-the-coming-decade-1385757204.

52. *See* UK Companies Act § 172 (2006) (listing "non-exhaustive factors" for a director to consider).

53. *Id.* at §172(1)(a) ("A director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard (amongst other matters) to. . . [t]he likely consequences of any decision in the long term.").

What needs to be done now is to frame an investor lawsuit or enact legislation that ensures this principle gets expressly set forth into Delaware law. Relevant Delaware case law has not squarely addressed the long-term assessment issue but rather has focused on more narrow fact situations such as failure of directors to discover fraud in the company or failure of directors to monitor for noncompliance with legal regulations.

In trying to rebalance the policy arguments in light of the current context of extreme short-termism, there is a spectrum of options, which a pension fund or other long-term investor has the flexibility to choose and pursue in Delaware courts. At the conservative end, a plaintiff shareholder could seize upon liability buzzwords from current Delaware case law—such as "known risks" or "red flags" or "systemic failure to monitor"—as justifying liability for a systemic failure to include long-term strategic planning and risk assessment in the decision-making process. At the more aggressive end, a plaintiff shareholder could seek broad Delaware court precedent requiring a general inclusion of long-term benefit and risk assessment in order to rationally meet the core goal of directors—to pursue long-term value maximization for shareholders.

There is also a middle ground: even if the Delaware courts are not ready to impose a uniform guideline requirement across all corporations, they may well be willing on a fact-specific basis to impose it on companies where: Much of the equity value of the company is clearly "future value"; there are clear known long-term risks facing the industry sector where the company operates; there are significant long-term debt obligations; "research and development" innovation is particularly critical to competition in a specific industry sector; the company is "too big to fail"; or directors have approved CEO compensation systems that highly reward CEOs for short-term performance, but not for long-term results.

To underscore that these are not academic options—but realistic ones—a brief overview of Delaware's evolving line of "duty to monitor" cases may be instructive.

1. Directors' Duty to Monitor: The Line of Cases from *Caremark* to *Stone v. Ritter*

The process of transforming Delaware case law to deal with the systemic short-term bias problem is in its formative stages. A good illustration of this point is the evolving case law on a director's duty of loyalty. Historically, the duty of loyalty was defined primarily in negative or passive terms. That includes historical prohibitions on conflict of interest or fraud by a director. But in a line of cases beginning with *In re Caremark International, Inc. Derivative Litigation*, a more proactive duty of loyalty has emerged.[54]

54. *In re* Caremark Int'l Inc. Derivative Litig., 698 A.2d 959 (Del. Ch. 1996).

These cases are also called "failure of oversight" cases—implying an *affirmative* duty to monitor important risks as part of the duty of loyalty.[55] This *Caremark* line of cases on an affirmative duty of loyalty has largely developed in response to a growing list of corporate meltdowns such as during the dot-com bust and the financial crisis of 2008. The cases have focused on the outcome of those catastrophes—and whether directors failed to adequately monitor fraud or legal compliance, which eventually led to major losses.

Obviously, these cases focus more on the symptoms of short-termism, rather than the problem of short-termism itself. After all, fraud and lack of legal compliance are generally a by-product of strong pressures for short-term profitability. And in these cases, the Delaware courts have only found liability under the duty of loyalty where the courts found the director's inattention or inaction in oversight was so egregious that it could be considered disloyal or in bad faith to have done nothing.[56]

That bad faith standard, also called "conscious disregard," is met when there were clear "red flags" or "known risks" that were ignored by directors. But even when there were no apparent red flags, Delaware courts have held that a breach of a director's duty of loyalty could be found if there was a "systemic failure" to monitor risks, or "utter failure" to put monitoring systems in place for fraud or compliance with laws.[57]

One other principle has also clearly emerged from this line of cases: there is no separate duty of good faith; rather it is subsumed under the duty of loyalty.[58] Put another way, a director is disloyal to the corporation where she fails to meet her duty of care or other duties in bad faith or through conscious disregard of known risks.[59]

The Delaware courts—and in once instance, the United States Court of Appeals for the Seventh Circuit—have addressed a series of uniquely fact-specific duty of loyalty cases and, in the process, have articulated these basic principles of analysis.

In *Graham v. Allis-Chalmers Mfg. Co.*, shareholders brought an action alleging the directors had failed to prevent violations of the federal antitrust laws

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55. *See generally* David P. Bancroft, *The Collateral Estoppel and Caremark Consequences of Criminal Convictions in Environmental Cases*, in CRIMINAL ENFORCEMENT OF ENVIRONMENTAL LAWS 137, 146 (ALI-ABA Course of Study, No. SE72, 2000) ("The decision of Delaware Chancery Court *In re Caremark International Inc.*, was widely believed by many criminal defense counsel to have harbingered an era of director personal liability for a convicted company's failure to have a company compliance program. The prior rule was that directors had no affirmative duty to prevent law violations by their company.").

56. *See generally* Leo E. Strine, Jr. et al., *Loyalty's Core Demand: The Defining Role of Good Faith in Corporation Law*, 98 GEO. L.J. 629 (2010).

57. *Id.*

58. *Id.*

59. *See id.* at 632 n.5, 689–95.

by Allis-Chalmers employees.[60] The Delaware Supreme Court held that, "absent cause for suspicion, there is no duty upon directors to install and operate a corporate system of espionage to ferret out wrongdoing which they have no reason to suspect exists."[61]

In *Caremar*k, shareholders brought an action against the directors, claiming they should have known about violations of the federal anti-referral payment laws that prohibit health care providers from paying remuneration to induce Medicare or Medicaid referrals. The Chancery Court formulated the "systemic failure of oversight" standard to apply to the facts and dismissed the case for insufficient facts.[62]

In *Abbott Laboratories Derivative Shareholders Litigation*, shareholders brought an action against directors of the pharmaceutical company for lack of oversight after the FDA gave the company repeated warnings about a violation before finally hitting the company with huge fines.[63] The Seventh Circuit held that this exhibited the requisite "systematic failure" to address the FDA issue.[64]

In *Stone v. Ritter*, the Delaware Supreme Court affirmed dismissal of a shareholder complaint alleging the directors never took the necessary steps to ensure reasonable compliance with the federal Bank Secrecy Act relating to money laundering.[65] The plaintiffs could not establish enough particularized evidence of an utter failure to monitor in light of certain steps the company had taken to monitor activities prohibited by the Act.[66]

In *In Re Chemed Corporation Derivative Litigation*, shareholders argued that directors should have known about pervasive, open wrongdoing in the corporation just by virtue of their positions as members of a relevant corporate auditing committee that would have naturally gathered and shared information about the conduct.[67] The Delaware District court rejected this allegation and distinguished this situation from *Abbott* because there the FDA itself put the

60. Graham v. Allis-Chalmers Mfg. Co., 188 A.2d 125, 127 (Del. 1963) ("The complaint alleges actual knowledge on the part of the director defendants of the anti-trust conduct upon which the indictments were based or, in the alternative, knowledge of facts which should have put them on notice of such conduct.").

61. *Id.* at 130.

62. *In re* Caremark Int'l Inc. Derivative Litig., 698 A.2d 959 (Del. Ch. 1996).

63. *In re* Abbott Labs. Derivative S'holders Litig., 325 F.3d 795, 811 (7th Cir. 2003).

64. *Id*. at 809.

65. Stone *ex rel.* AmSouth Bancorporation v. Ritter, 911 A.2d 362 (Del. 2006).

66. *Id.* at 373 ("Accordingly, we hold that the Court of Chancery properly applied *Caremark* and dismissed the plaintiffs' derivative complaint for failure to excuse demand by alleging particularized facts that created reason to doubt whether the directors had acted in good faith in exercising their oversight responsibilities.").

67. *In re* Chemed Corp., S'holder Derivative Litig., No. CV 13-1854-LPS-CJB, 2015 WL 9460118, at *30 (D. Del. Dec. 23, 2015), report and recommendation adopted *sub nom*. KBC Asset Mgmt. NV v. McNamara, No. CV 13-1854-LPS-CJB, 2016 WL 2758256 (D. Del. May 12, 2016) ("In the absence of such particularized allegations (or something like them), the asserted pervasiveness and duration of the improper billing scheme does not strongly suggest the Board's bad faith intent or knowledge of the conduct.").

Abbott board members on notice of corporate violations and required them to share the information.[68]

In *Citigroup Shareholder Derivative Litigation*, shareholders sued directors for failure to monitor "business risk," specifically exposure to subprime market loans.[69] Citing insufficient conclusory allegations seeking to link a large loss to flawed director oversight, the Chancery Court dismissed the case. The decision was critical of any attempts to second-guess decisions in hindsight and urged that any cause of action must focus on the particularized flaws in the "process" of decision-making instead.[70] So this case in no way foreclosed the possibility that a failure to adequately monitor business risk would be appropriate.

A recent article by Chief Justice Strine in the GEORGETOWN LAW JOURNAL goes through a detailed analysis of the duty of loyalty line of cases with *Caremark* issues of oversight.[71] In that article, Chief Justice Strine and his co-authors refer to two types of monitoring or oversight cases: one where an actual decision was made and a second where there was merely unconscious inattention given to the problem and no decision was made.[72] In the first context, there can either be cases where there were "yellow or red flags" or those where there were no such warnings.[73]

Several quotations from this article by Strine and his co-authors make clear that the Delaware courts are very actively looking at developing this law:

- ". . .in *In re Caremark International Inc. Derivative Litigation*, Chancellor Allen underscored the importance of good faith by sending the message that a director's duty of loyalty extended to the increasingly important context of monitoring."[74]

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68. *Id.* at *34 ("With regard to this assertion, the Court does not doubt that the magnitude and duration of alleged misconduct can be a *factor* that bears on whether it can be reasonably inferred that board members knew of that misconduct. But in *Abbott Labs,* (as set out above) and in the other three cited cases, the alleged facts conveyed a much stronger picture of direct board knowledge of misconduct than what is contained in the Plaintiffs' Complaint. It is those stronger facts regarding director knowledge, not present here, that appears to have made the difference in those cases as to the issue of demand futility.").

69. *In re* Citigroup Inc. S'holder Derivative Litig., 964 A.2d 106 (Del. Ch. 2009).

70. *Id.* at 126 ("To the extent the Court allows shareholder plaintiffs to succeed on a theory that a director is liable for a failure to monitor business risk, the Court risks undermining the well settled policy of Delaware law by inviting Courts to perform a hindsight evaluation of the reasonableness or prudence of directors' business decisions.").

71. Strine, *supra* note 56, at 629.

72. *Id.* at 695 ("Put simply, there is nothing new about recognizing that a conscious failure to make a good faith effort to comply with the required duty of care is categorically distinct from a mere failure to fulfill that duty in a specific circumstance.").

73. *Id.* at 686 ("In the context where disinterested directors made a specific decision regarding monitoring—such as how to follow up on yellow or red flags suggesting law-compliance problems—the focus of the loyalty prong of the business judgment rule inquiry was on whether the directors had undertaken a good faith effort to make a reasoned decision in the interest of the corporation.").

74. *Id.* at 685.

- "As he [Chancellor Allen] conceptualized it, directors could be subject to liability for failing to monitor the ongoing operations of the corporation—or, in chancellor Allen's alternative words, "to exercise appropriate attention" in two contexts. . ..."[75]
- "In the first [context] the board may have made a specific decision about a matter. In that case, the business judgment rule applied."[76]
- "In the [first] context where disinterested directors made a specific decision regarding monitoring—*such as how to follow up on yellow or red flags suggesting law*-compliance problems—the focus of the loyalty prong of this business judgment rule inquiry was on whether the directors had undertaken a good faith effort to make a reasoned decision in the interest of the corporation."[77]
- "The other [second] related context in which the board could face liability for failure to monitor involved a claim regarding what Chancellor Allen called the board's 'unconsidered inaction' . . . 'Chancellor Allen famously addressed that context by holding that directors had a duty to assure that a corporate information gathering and reporting system [] exists which represents a good faith attempt to provide senior management and the Board with information respecting material acts, events, or conditions within the corporation, including compliance with applicable statutes and regulations.'[78]

But, as Strine noted, to avoid disincentivizing directors serving for fear they would be blamed for lack of oversight and monitoring of a corporate catastrophe, *Caremark* held that:

> "Only a sustained or systematic failure of the board to exercise oversight—such as an utter failure to attempt to assure a reasonable information and reporting system exists—will establish the lack of good faith that is a necessary condition to liability."[79]

In light of the highly cautious approach taken to these cases, there is an open question whether Delaware courts would impose a duty of loyalty that insists upon systematic long-term strategic planning and accompanying assessments of long-term consequences (both benefits and risks).

On the other hand, failure to proactively insist on long-term strategic plans and risk assessment goes to the *very core* of what a director is supposed to be doing. She is supposed to act in the best interests of the shareholders by maximizing long-term profitability and wealth creation. Her duty of loyalty is to act in good faith in the best interest of the shareholders. It approaches riverboat gam-

75. *Id.* (quoting *In re* Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 967 (Del. Ch. 1996)).

76. *Id.*

77. *Id.* at 686.

78. *Id.* (quoting *In re* Caremark*,* 698 A.2d at 968–69).

79. *In re* Caremark*,* 698 A.2d at 971.

bling to press for profits in the short-term when the long-term risks inherent in such a decision are not even considered seriously in the analysis.[80] It truly would be a systemic failure to fail to attempt to assure that a reasonable long-term information reporting system exists. And if there are any "yellow flags" or "red flags" about long-term risks, that would only heighten the director's obligation to monitor.

Any reasonable director should be aware of the known risks of failure to engage in long-term planning or assessment of long-term consequences. Indeed, one can argue that it is much easier to prove conscious disregard and breach of loyalty by a director for not assessing long-term consequences in good faith than it is in the fraud-monitoring cases in the earlier *Caremark* line of oversight cases where the problem was often hidden. This is particularly true if: Much of the value of the corporation is tied up in future value, there is little in the way of research and development, the directors are approving a large compensation package for a CEO based on short-term profitability criteria, or there is no long-term strategic plan or assessment of long-term risks related to decisions made to create short-term profitability. In other words, the whole decision-making process is systemically biased toward short-term thinking, and there is no offsetting strategic analysis of what is given up in the long-term.

On a principled basis, imposing liability in this fact situation would not penalize a good director. Every industry has a known set of at least four or five major risks.[81] It is essential to have a coherent long-term strategy for investment that deals with risks and opportunities if long-term value maximization—particularly future value—is to occur. It is unfortunately the line of least resistance to grab short-term profits at the expense of the long-term for the company. The symptoms of short-termism, such as the very internal fraud and lack of legal compliance that were featured in the *Caremark* line of cases, should diminish substantially if long-term assessment of consequences is in place.

III. WHY EXTENSION OF THE DUTY OF LOYALTY TO INSISTENCE ON LONG-TERM ANALYSIS SHOULD NOT BE A JUDICIAL OVERREACH

Delaware courts could impose a duty of loyalty on directors to deal with the short-termism problem. The question is whether they will let the directors off the hook, out of deference to the long-standing BJR.[82]

Short-termism refers to a process of decision-making that concretely fails to weigh long-term consequences (good or bad).[83] There are several reasons why

80. One only need look at the subprime mortgage profits fiasco to see this problem. *See The 2008 Financial Crisis*, *supra* note 14.

81. Industries can easily have dozens or hundreds of major risks, but for the sake of planning it should be limited to only reasonably foreseeable risks.

82. *See* Johnson, *supra* note 47.

83. Emeka Duruigbo, *Tackling Shareholder Short-Termism and Managerial Myopia*, 100 KY. L.J. 531, 531 (2012) ("Short-termism denotes the phenomenon by which some corporate managers, responding to pressure from investors or acting to bolster their own position, advert their at-

Delaware courts could expand their previous precedent to hold directors accountable for a short-term bias that ignores long-term consequences, despite the presumption of the BJR.

First, short-termism is a logically and inherently flawed decision-making process *if there is no systematic assessment of long-term consequences* (good or bad). In balancing benefits and risks—the failure to include vital risks (and benefits) creates inherent bias—no matter how well meaning the directors may be. When those decisions involve lots of other people's money, that is a big problem.

Second, a mere Delaware court-imposed guideline insisting on systematic long-term assessment in connection with major investment decisions does not trigger the traditional reasons that Delaware courts use to justify BJR restrictions on liability. Imposing a duty to monitor long-term consequences as part of the decision-making process in no way is "second-guessing" the judgments that come out of that process.[84] A director may still make a short-term-oriented profit decision, but at least he is not ill-informed when he makes that decision. There is no conclusion that a loss occurred and therefore the process must be flawed.[85] The only way a causal connection can be established for liability is if there was a systematic failure—as there appears to be in most U.S. corporations—to even have a long-term strategy or assessment. Nor would there be a chilling effect on people interested in serving on corporate boards. Insisting on a long-term assessment as part of overall corporate decisions should make a rational director more comfortable, not less so.[86] And indeed the presence of a protocol for long-term strategy and assessment can inoculate that director from liability. Finally, it does not impose "best practices" on directors. Establishing a duty to monitor long-term consequences as part of a decision-making process is

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tention and exert their energies to achieving short-term profitability, virtually eschewing longer-term considerations."); Kenneth McNeil & Richard Miller, *The Profitability of Consumer Protection: Warranty Policy in the Auto Industry*, 25 ADMIN. SCI. Q. 407, 407–427 (Sept., 1980) (The National Science Foundation funded this study of the auto industry while Japanese automobile manufacturers were dramatically increasing their market share in the U.S. market. Through market surveys, the study documents how short-term bias in accounting systems blinded American auto manufacturers to the long-term risks of destroying customer loyalty over time through product defects and poor repair service—a blindness that could easily have been cured by systemic long-term risk assessment and monitoring tools).

84. A. Christine Hurt, *The Duty to Manage Risk*, 39 J. CORP. L. 253, 257 (2014) ("Courts will look not at the substance of decisions, but to whether boards were rational in their decision-making processes."). *See also* Claire A. Hill & Brett H. McDonnell, *Reconsidering Board Oversight Duties After the Financial Crisis*, 2013 U. ILL. L. REV. 859, 862 (2013) ("Chancellor Chandler was clearly quite reluctant to recognize a duty to monitor general business risk, fearing that such a duty would lead to judicial second-guessing of board decisions, precisely the sort of second-guessing that the business judgment rule is meant to block.").

85. *Id.*

86. *See generally* Margaret M. Blair & Lynn A. Stout, *Trust, Trustworthiness, and the Behavioral Foundations of Corporate Law,* 149 U. PA. L. REV. 1735, 1737–38 n.3 (2001) (reviewing and summarizing citations to rational corporate director theory and economic behavior).

not a matter of best practices.[87] This duty is merely to insist on some systematic assessment. That is different from the current situation, where there is often *no* systematic assessment of long-term consequences; and there is conduct totally incompatible with long-term durable wealth creation and value maximization for the shareholder.

Third, merely hiring "disinterested directors" does not obviate a duty to monitor long-term consequences as part of a decision-making process. In the past, Delaware courts have looked to independent directors as more rational and less biased. But even disinterested directors will make flawed decisions without adequate information on long-term, as well as short-term, considerations that affect long-term wealth of the corporation.

Fourth, Delaware courts have already crossed the bridge of imposing "proactive" duties on directors. The old prohibitions on "fraud and conflict of interest" are negative constraints. But courts have made clear that director obligations also require "positive" or "proactive" steps by directors, such as in monitoring and assessing information.

Even if Delaware courts insisted on tying this duty more closely to existing law on "duty to monitor," the assessment of long-term consequences appear to fall squarely within that scope of liability found for those cases involving red flags or ignoring known risks; or systemic (meaning repeated and complete) failure to monitor compliance with laws. Failure to do any long-term strategic assessment on an ongoing basis clearly would be a red flag or a known risk in today's world. And total failure to do long-term planning appears to be a systemic failure. Following this logic, a principled analysis for imposing a strategic duty to look at long-term consequences could look something like the following:

If a reasonable process for developing that long-term strategy and assessment (or "means") is *totally missing* from a particular corporate decision where that information would be material and relevant to a major decision, then a plaintiff should be allowed to survive a motion to dismiss if:

(1) Plaintiff can show that a reasonable strategic plan and assessment metrics were not in place to address those long-term consequences when the flawed decision was actually made that led to major losses;

(2) If they had been in place, that important material and relevant information would have been available to issue strong red flag warnings; and

(3) If those red flags had been raised, no decision could have reasonably been made that would have resulted in the losses without bad faith or conscious disregard of the duty of loyalty's obligation to engage in a systematic assessment of long-term strategy.

87. William W. Bratton, Lyondell*: A Note of Approbation*, 55 N.Y.L. SCH. L. REV. 561, 562 (2011) (describing the difficulty of imposing best practice liability on corporate decision-making).

With this type of "principled analysis" test, it should benefit a company to have long-term strategic plans in place, because the director could protect herself by easily justifying that:

(1) A long-term strategic plan and assessment systems were in place that addressed the known risks of a decision that, in hindsight, turned out to be bad and created losses;

(2) The board had the benefit of that long-term thinking about "consequences" that had gone into those plans before making that decision; and

(3) A good faith "process" set up by the board therefore inoculates it against any liability for later loss in a way that restores balance to a reasonable process while protecting the director from liability for a bad decision.

If boards of directors do not insist on longer-term strategic plans and related assessment monitoring, and the inherent business risks were not analyzed in terms of such a long-term strategy and assessment, then:

(1) The plaintiff could plead the three steps above with particularly; and

(2) The BJR rule should not protect directors from liability for making such decisions about other people's money where the decision was made strictly in light of short-term risks and benefits, with no consideration of offsetting strategies for maximizing longer-term benefits and minimizing longer-term risks, and that process (if it had been in place) would likely have made a difference in the decision made.

Nevertheless, whatever option is selected, something needs to be done. It will take a carefully pled case for the Delaware courts to fill the gap between what they have said is the goal of director decision-making—and the actual duties of directors under the BJR.

But once the gap is filled, corporate counsel will automatically push boards to plan for the long-term, driving sustainable value creation and making shareholder-company engagements much more effective.[88] All indications are that—

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88. For example, depending on the industry, such a plan may include processes for:

- strategic and scenario planning 5 to 15 years into the future;
- setting 5- to 10-year strategic goals and targets;
- assessing risk to the current business model 5 to 15 years into future;
- long-term incentive compensation plan goals and pay for performance aligned with 5-year or longer goals;
- research and development and innovation reporting on realizing future value;
- reporting on relative research and development investment compared to peers;
- measuring and reporting on capital efficiency (such as return on equity or return on invested capital) over 10 years;
- measuring and reporting future value;
- reporting on CEO and named officer succession planning aligned to strategy for the next 10 years;

when a truly respected long-term investor with a creative lawsuit arrives—Delaware courts would be eager to use it to frame policy to achieve the very goals Chief Justice Strine describes: building long-term, durable wealth and aligning corporations with overall goals for societal economic prosperity.

IV. THE MAJOR CONSEQUENCES OF FAILING TO FILL THIS GAP IN THE LAW

This question of controlling direct decision-making to protect long-term shareholder interests is not academic. Indeed, the real economic stakes of solving this problem grow ever more enormous, and the impact is increasingly global.

The impact of short-termism can be disastrous, whether seen from the perspective of a liberal or conservative economist. For example, a Credit Suisse report shows that that one percent of the world's population owns half the world's wealth, and the disparity is increasing.[89] In the United States, the wealthiest one percent have seen their share increase to nearly a quarter of all the country's wealth, while the poorest have less than five percent.[90]

Edward Conard, founding partner of Bain capital and a conservative economic writer, justifies this inequality and related tax breaks for the rich on a key predicate[91]: This wealth and tax breaks foster innovation—research and development. That, in turn, creates jobs and economic growth, which creates a multiplier effect where more people with more jobs get trained in better skills. Therefore, he reasons, everyone benefits.

Yet, Credit Suisse research and other data show that such innovation is not happening in the top 1500 corporations. Research and development investments seem confined to only about 100 of the top 1500.[92] Indeed, research done at the International Monetary Fund indicates that high levels of persistent income inequality are associated with reduced economic growth, macroeconomic instability, concentrated political and decision-making power, suboptimal use of human resources, political and economic instability, and increased crisis risk.[93] If any of this is true, Conard's logic falls on its face.

- the CEO role profile defined relative to 10- to 20-year strategy; and
- assessing talent with potential for C-Suite leadership in 10 to 15 years.

89. Rupert Neate, *Richest 1% Own Half the World's Wealth, Study Finds,* GUARDIAN (Nov. 14, 2017), https://www.theguardian.com/inequality/2017/nov/14/worlds-richest-wealth-credit-suisse.

90. *Id.*

91. *See generally* EDWARD CONARD, THE UPSIDE OF INEQUALITY: HOW GOOD INTENTION UNDERMINES THE MIDDLE CLASS (Penguin Random House ed., 2016).

92. Neate, *supra* note 89.

93. INT'L MONETARY FUND, CAUSES AND CONSEQUENCES OF INCOME INEQUALITY: A GLOBAL PERSPECTIVE 7 (2013), https://www.imf.org/external/pubs/ft/sdn/2015/sdn1513.pdf ("If the income share of the top 20 percent increases by one percentage point, GDP growth is actually 0.08 percentage point *lower* in the following five years, suggesting that the benefits do not trickle down. Instead, a similar increase in the income share of the bottom 20 percent (the poor) is associated with 0.38 percentage point *higher* growth.") (original emphasis).

In this light, it is no surprise that Chief Justice Strine is strident about these issues of control of corporate decision-making for societal growth and well-being. One need look no further than how Strine reinforces his concerns in a pair of very recent law review articles from Yale and Harvard:

> Most Americans have become "forced capitalists" who must – by virtue of government tax and retirement policies – give over a large portion of their wealth to the stock market to fund their retirements and their children's educations. As a result, the actual human beings whose capital is invested by these intermediaries do not directly vote on who sits on corporate boards, do not have the option to buy and sell the securities of particular companies in their 401(k) programs, and retain only very limited rights of exit from the market without facing expropriatory levels of taxation.[94]

> [T]he leading corporate law in the United States, that of Delaware, requires corporate directors to manage the corporation in the best interests of the corporation's stockholders. . . . This, of course, does not mean that the board must always bend to the whims of any momentary stockholder majority, but it does mean that the directors must govern the corporation so as to generate the most sustainable profitability for the corporation's equity owners. . . . Under that structure, only stockholders are entitled to elect directors, vote on important transactions, sue to enforce fiduciary duties, and exercise other statutory rights. Put simply, they are the only constituency given power over the board.[95]

Strine's call here is clear and to the point: pension funds that represent these millions of beneficiaries should step up and exercise their responsibilities.[96] And a key way to do so is by helping Delaware courts develop the rules of the road for a new world where long-term consequences will rule the day, whether corporations plan for it or not.

V. Supplementing Long-term Investors' Traditional Reform Strategies Using the Delaware Books and Records Statute.

Investors are not confined to just filing a lawsuit in Delaware courts to frame legal issues for reform in the process of corporate decision-making to conform to long-term goals rather than extreme short-termism. It is not uncommon for a Delaware Court to order that a shareholder be allowed to inspect books and records under Delaware General Corporation Law § 220 to investi-

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94. Strine, *supra* note 13, at 444.

95. *Id.* at 440–41.

96. *Id.* at 443–44 ("Most of the stock of American public corporations is no longer owned directly by human beings but is instead owned by institutional investors such as mutual or pension funds.") (citation omitted).

gate and evaluate wrongful conduct.[97] The text of § 220 spells out this procedure.[98]

A long-term investor's use of the Delaware statute on books and records inspections can accomplish two goals at the same time. First, it can enable access to detailed internal company documents necessary to investigate just how much monitoring and assessment is being done, as part of determining whether directors have ignored their duty to assess long-term consequences. Second, it provides a potential "disclosure" remedy producing more transparency on what exactly is going on, allowing efforts at cooperative engagement to be more meaningful.

Some of the types of purposes for which the books and records can be directed are spelled out in a recent Delaware case: *Louisiana Municipal Police Employees Retirement System v. Morgan Stanley.*[99] In that case, a pension fund ("LAMPERS") sought to inspect the books and records of Morgan Stanley to determine whether the appropriate legal strategy had been taken "arising out of the company's involvement with auction rate securities."[100] The court granted the inspection except for information that was not reasonably required. Further, the court cited a treatise[101] and quoted a number of independent grounds for the requisite statutory showing of "proper purpose."[102]

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97. *See* 1 EDWARD P. WELCH ET AL., FOLK ON THE DELAWARE GENERAL CORPORATION LAW § 220.6.3, at GCL–VII–202–209 (5th ed. 2010 Supp.) (internal footnotes omitted), *quoted in* City of Westland Police & Fire Ret. Sys. v. Axcelis Techs., Inc., 1 A.3d 281, 289 n.30 (Del.2010).

98. DEL. CODE ANN. tit. 8, § 220 (West 2010).

99. La. Mun. Police Emp.'s Ret. Sys. v. Morgan Stanley & Co. Inc., No. C.A. 5682-VCL, 2011 WL 773316, at *6 (Del. Ch. Mar. 4, 2011).

100. *Id.* at *2.

101. *Id.* at *6 (citing WELCH ET AL., *supra* note 97, at GCL–VII–202–206).

102. *Id.* (citing WELCH ET AL., *supra* note 97, at GCL–VII–202–206). These grounds include a shareholder's desire to:

- investigate allegedly improper transactions or mismanagement;
- clarify an unexplained discrepancy in the corporation's financial statements regarding assets;
- investigate the possibility of an improper transfer of assets out of the corporation;
- ascertain the value of stock;
- aid in litigation instituted to contact other stockholders regarding litigation and invite their association in the case;
- inform fellow shareholders of one's view concerning the wisdom or fairness, from the point of view of the shareholders, of a proposed recapitalization and encourage fellow shareholders to seek appraisal;
- discuss corporate finances and management's inadequacies and then, depending on the responses, determine stockholder sentiment for either a change in management or a sale pursuant to a tender offer;
- inquire into the independence, good faith, and due care of a special committee formed to consider a demand to institute derivative litigation;
- communicate with other stockholders regarding a tender offer;
- communicate with other stockholders in order to effectuate changes in management policies;

Indeed, Delaware courts encourage plaintiff-shareholders to use this procedure when considering derivative litigation. Records inspections can help the shareholder plead facts with enough particularity to overcome the shareholder derivative futility requirement.

In *Amalgamated Bank v. Yahoo!*, the plaintiff-shareholders' initial complaint based on Yahoo!'s questionable executive compensation decisions failed.[103] They then used § 220 to obtain books and records necessary to file an amended complaint.[104] The information the shareholders obtained from that request helped their complaint survive dismissal in a case that was factually—and procedurally—similar to the famous *Disney* case regarding Michael Ovitz's executive compensation package.

Given the Delaware judiciary's consistent statements about the need to address short-term forces in the corporate governance system, a corporation's lack of reasonable reporting on durable long-term business planning and risk management practices should be a proper purpose for gaining access to related company books and records. Decisions on company refusals to allow books and records demands would provide an avenue for Delaware courts to clarify corresponding director duties.

CONCLUSION

The short-termism problem and its consequences are systemic. For example, funding at some public pension funds is under 50 percent of liabilities.[105] While the causes of such underfunding are multifaceted, the situation is unsus-

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- investigate the stockholder's possible entitlement to oversubscription privileges in connection with a rights offering;
- determine an individual's suitability to serve as a director;
- obtain names and addresses of stockholders for a contemplated proxy solicitation; or
- obtain particularized facts needed to adequately allege demand futility after the corporation has admitted engaging in backdating stock options.

103. Amalgamated Bank v. Yahoo! Inc., 132 A.3d 752, 777 (Del. Ch. 2016) ("The trustee for an index fund has analogous authority. In this case, Amalgamated even provided decisions by this court recognizing its authority to make Section 220 demands on behalf of funds for which it served as trustee. Amalgamated satisfied the form and manner requirements . . . . Amalgamated's Demand described the purposes for the inspection as follows: Amalgamated is making this Demand to: (1) investigate Yahoo's payment of what appears to be excessive compensation to Yahoo's former Chief Operating Officer ("COO"), Henrique de Castro ("Mr. de Castro"); (2) assess the independence of the non-management members of Yahoo's Board, including the members of the Compensation and Leadership Development Committee (the "Compensation Committee"), who would have approved any compensation paid to Mr. de Castro; and (3) investigate the circumstances surrounding Mr. de Castro's departure from the Company.").

104. *Id.* at 799.

105. According to the Pew Charitable Trusts, aggregate funded ratios of state public pension plans dropped to 72 percent in 2015 from 75 percent in 2014. Funded ratios ranged from 37 percent in New Jersey to 104 percent in South Dakota. Greg Mennis, *Measuring the Fiscal Health of State Pension Plans*, PEW CHARITABLE TRS. (July 19, 2017), http://www.pewtrusts.org/en/research-and-analysis/analysis/2017/07/19/measuring-the-fiscal-health-of-state-pension-plans.

tainable. But the problem can be solved. Studies show corporate profits can almost double when a corporation has long-term planning.[106] The problem truly presents a shared opportunity for long-term investors like pension funds and companies to build a stronger economy and benefit both corporations and their investors, including the beneficiaries of the pension funds themselves.

Courts cannot unilaterally change corporate conduct. But Delaware courts can provide a critical "*rudder*" for steering corporate directors in a new direction, if long-term investors assist the Delaware courts in making new law by bringing appropriate cases that raise these issues. Delaware courts are aggressively trying to solve the short-termism problem and are looking for creative ways to do it.

Unfortunately, all the Delaware courts can do is to encourage such lawsuits to be brought. Chief Justice Strine has clearly sought such assistance from long-term institutional investors and chastised them for not being more aggressive in pushing for long-term sustainable wealth creation.[107] There would be no better time to bring such litigation than when a court encourages it.

Moreover, responsible corporate directors with a clear view of the requirements for durable wealth creation should welcome further clarity on their strategic planning and risk management duties. Balancing long-term considerations against short-term pressures can only help corporations increase profitability and reduce risks.

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106. *See* VAN CLIEAF ET AL., *supra* note 5, at 36–44.

107. *See* Leo E. Strine, Jr., *Who Bleeds When the Wolves Bite?: A Flesh-and-Blood Perspective on Hedge Fund Activism and Our Strange Corporate Governance System*, 126 YALE L.J. 1870, 1970 (2017) ("If empowering short-term investors turns out to be optimal for our society and its human citizens, that seems like a very improbable and unsustainable triumph of the law of unintended consequences. Call me old-fashioned, but it would be more comforting to know that those with the power over the capital—equity, debt, and most *important*, labor—of ordinary Americans were duty-bound to align their thoughts and actions with those they supposedly represent.") (emphasis added).