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The Delaware Way: Deference to the Business Judgment of Directors Who Act Loyally and Carefully

Read Why Business Choose Delaware (/eng/why_delaware.shtml)

The Delaware General Corporation Law's (http://delcode.delaware.gov/title8/c001/index.shtml) central mandate appears in Section 141(a) (http://delcode.delaware.gov/title8/c001/sc04/index.shtml); it provides that the business and affairs of every Delaware corporation are managed by or under the direction of the corporation's board of directors. In discharging their duty to manage or oversee the management of the corporation, directors owe fiduciary duties of loyalty and care to the corporation and its stockholders.

Business judgment rule: Although some major transactions require the consent of stockholders as well as the approval of the board, the board generally has the power and duty to make business decisions for the corporation. These decisions include establishing and overseeing the corporation's long-term business plans and strategies, and the hiring and firing of executive officers. Delaware law affords directors making such decisions a set of presumptions—known as the "business judgment rule"—that, so long as a majority of the directors have no conflicting interest (see "duty of loyalty" below) in the decision, their decision will not later be second-guessed by a court if it is undertaken with due care and in good faith. The business judgment rule, which applies even if the business decision later turns out to have been unwise, is the centerpiece of Delaware corporation law.

Duty of loyalty: Broadly stated, the duty of loyalty requires directors to act in good faith to advance the best interests of the corporation and, similarly, to refrain from conduct that injures the corporation.

Fundamentally, the duty of loyalty begins with ensuring that the corporation acts consistently with its charter from Delaware, a charter that typically permits the corporation to undertake any lawful business by any lawful means. A director therefore cannot cause a Delaware corporation to violate the law in order to make a profit. Rather, directors must exercise good-faith efforts to ensure that the corporation has policies to ensure compliance with the regulatory laws applicable to its operations (such as environmental, labor, and criminal laws) and to monitor senior management's adherence to those policies. Although Delaware law gives directors wide discretion to decide how a corporation should seek profit, the duty of loyalty requires them to consider as well what legal, ethical course of action will produce the best outcome for the corporation's stockholders.

Delaware law requires directors to devote their loyalty to the corporation and its stockholders, without consideration to their self-interest. Thus, the duty of loyalty prohibits directors from, for example, causing the corporation to engage in an unfair transaction in which the director has an interest, taking unreasonable action to keep their director positions, or profiting from the use of confidential corporate information. Generally, the duty of loyalty forbids any action that subordinates the best interests of the corporation and its stockholders to a director's personal motive.

If a majority of the board has a conflicting interest in a transaction challenged in court, the board's decision may not be protected by the business judgment rule. Rather, Delaware courts http://courts.delaware.gov/overview.stm) will generally require the directors to demonstrate that a self-dealing transaction was entirely fair to the corporation. For that reason, the Delaware courts encourage interested directors to adopt procedural protections—like impartial and independent decision-makers—to help ensure that the transactions are fair. Further, because Delaware law seeks to protect minority investors, major corporate transactions with controlling stockholders are subject to this searching fairness review even if procedural protections have been put in place.

Duty of care: In managing and overseeing a corporation's business and affairs, directors must both make decisions and rely on subordinates. The duty of care requires directors to make informed business decisions, but recognizes that directors must make decisions constantly and cannot spend forever on each one. Thus, directors are not required to review all information in making their decisions—only the information that is material to the decision before them. Nevertheless, in evaluating information provided to them by management, directors are expected to review the information critically and not accept it blindly.

Whether directors have satisfied their duty of care typically depends on the specific circumstances. The Delaware courts (http://courts.delaware.gov/overview.stm) will generally consider how much time the directors had to review the information, what information they reviewed, how critically they reviewed that information, and whether they sought expert financial or legal advice. Because rational stockholders would not want directors to fear that good-faith, but unavoidably risky, business decisions would later be second-guessed as a lapse in care, Delaware law typically applies a "gross negligence" standard to determine whether directors have satisfied their duty of care. In other words, although directors are expected to act with reasonable diligence, Delaware courts will only intervene if the directors have drastically departed from what would be expected of a careful fiduciary. Further, Delaware law allows corporations to include in their charters a provision immunizing directors from personal monetary liability for violating their duty of care—such a provision may not, however, shield directors from liability for violating their duty of loyalty. This provision, Section 102(b)(7 http://delcode.delaware.gov/title8/c001/sc01/index.shtml), is designed to facilitate management creativity and good-faith risk taking to enhance stockholder wealth.

For information on the law firms and corporate service providers that authored these articles, please visit our acknowledgements page (/acknowledgements.shtml). The State of Delaware is grateful for their assistance.

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Why Businesses Choose Delaware

The question is often asked—why Delaware? Why does this small state (the second smallest in the United States) occupy such a large place in the world of business entities? The question has several answers, but most of the answers are not what people think. For example, Delaware is not a tax haven, Delaware does not charter secret corporations exempt from public knowledge and inquiry, and Delaware is usually not the cheapest option for incorporation. We are far more like Bergdorf Goodman or Tiffany than we are like the Dollar Store. You pay for quality and service.

Delaware is neither "management-friendly" nor "stockholder-friendly"; its aim is to provide both managers and investors with laws optimal for engaging in ethical and profitable business, by balancing the need for managerial flexibility with strong tools to hold managers accountable for using that flexibility to advance the best interest of investors. Delaware's judges are impartial and not beholden to special-interest donors or shifting political winds. Unlike in many other states, Delaware corporate law cases are tried exclusively by professional judges, and not by juries.

Delaware has been the premier state of formation for business entities since the early 1900s. Today, more than one million business entities have made Delaware their legal home. Although the number of entities organized in Delaware is impressive, even more important is the fact that so many large and important corporations whose shares are listed on major stock exchanges are incorporated in Delaware. Indeed, more than 60 percent of the Fortune 500 companies are incorporated in Delaware. But organization in Delaware is not only for U.S. entities—companies around the world can take advantage of Delaware's benefits. [See Beyond the Borders: Delaware's Benefits for International Business (/eng/borders.shtml).]

A number of factors have led to Delaware's dominance in business formation.

First, the statute—the Delaware General Corporation Law (http://delcode.delaware.gov/title8/c001/index.shtml) ("DGCL") is the foundation on which Delaware corporate law rests. [See Delaware's Sound and Enabling Statute (/eng/statute.shtml).] The DGCL offers predictability and stability. It is shaped by corporate-law experts and protected from influence by special-interest groups. The Delaware legislature every year reviews the DGCL to ensure its ability to address current issues.

The DGCL is also an enabling statute. Delaware's corporate statute is not a detailed, prescriptive "company law" such as exists in many nations. Instead, the DGCL includes a few important mandatory requirements to protect investors and otherwise provides flexibility for corporations to carry out their business. Delaware has also applied the principles of the DCGL to create leading statutes for business entities other than corporations [See Delaware's Alternatives to Corporations (/eng/alternatives.shtml).]

worldwide for its judicial system and the expert and impartial judges that decide its corporate cases. [See Litigation in the Delaware Court of Chancery and the Delaware Supreme Court (/eng/litigation.shtml).] The Delaware Court of Chancery (http://courts.delaware.gov/Chancery/) is a specialized court of equity with specific jurisdiction over corporate disputes. Without juries, and with only five expert jurists (http://courts.delaware.gov/Chancery/judges.stm) selected through a bipartisan, merit-based selection process, the Court of Chancery is flexible, responsive, focused and efficient. Cases from the Court of Chancery are appealed directly to the Delaware Supreme Court (http://courts.delaware.gov/Supreme/), which is the ultimate word on Delaware law. The Supreme Court has five justices (http://courts.delaware.gov/Supreme/justices.stm), each of whom has considerable experience with Delaware's business law. Delaware's courts also offer a number of options for dispute resolution outside of litigation. [See Delaware's Options for Alternative Dispute Resolution (/eng/alternatives.shtml).]

Third, the case law—the Court of Chancery and the Delaware Supreme Court both have a historical tradition of issuing reasoned written opinions (http://courts.delaware.gov/opinions/) supporting their decisions, thus allowing a significant body of precedent to accumulate over many decades. Judges, not juries, decide all corporate cases and must give reasons for their rulings. The resulting body of case law provides detailed and substantive guidance to corporations and their advisors.

One of the key concepts embodied in Delaware case law is the "business judgment rule," which is a judicial recognition that law-trained judges should not second-guess business decisions made by directors in good faith and with due care—even if the decisions turn out badly. Along with the business judgment rule, the case law includes guidelines for directors in upholding their fiduciary duties of loyalty and care. [See The Delaware Way: Deference to the Business Judgment of Directors Who Act Loyally and Carefully (/eng/delaware_way.shtml).]

Fourth, the legal tradition—along with a sophisticated judiciary, Delaware has an ample supply of lawyers (http://www.dsba.org/) expert in Delaware corporate law. Delaware's statutes and case law provide a base of knowledge for attorneys who specialize in Delaware transactional matters and who practice in front of Delaware's courts. These professionals also help the legislature by continually reviewing the business statutes and annually recommending changes to keep Delaware's law current. [See Delaware's Sound and Enabling Statute (/eng/statute.shtml).] No matter where a Delaware entity is headquartered, it can find expert attorneys in Delaware to help it navigate issues of Delaware law.

Fifth, the Delaware Secretary of State—the Division of Corporations (http://corp.delaware.gov) of the Delaware Secretary of State's Office (http://sos.delaware.gov) exists to provide corporations and their advisors with prompt and efficient service. Incorporations provide a major portion of the State's revenue, so Delaware takes its role seriously. The personnel of the Division of Corporations view themselves as employees of a service business, and the Division meets worldwide quality standards as evidenced by its ISO 9001 certification (http://corp.delaware.gov/CorpISO9001Statement.pdf).

Delaware's Division of Corporations is open 15 hours a day to accommodate requests for filings from around the world; it offers specialized and expedited services (http://corp.delaware.gov/expserv.shtml) (including one-hour, two-hour, and 24-hour service) for urgent and time-sensitive matters. [See Forming a Delaware Corporation (/eng/formation.shtml).] The Division of Corporations, in conjunction with expert Delaware lawyers and experienced supporting businesses such as Delaware registered agents, can handle nearly any situation.

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