

FIDUCIARY EXEMPTION FOR PUBLIC NECESSITY: SHAREHOLDER PROFIT, PUBLIC GOOD, AND THE HOBSON'S CHOICE DURING A NATIONAL CRISIS

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INTRODUCTION

The financial crisis of 2008 has posed innumerable problems in law, policy, and economics. A key event in the history of the financial crisis was Bank of America's acquisition of Merrill Lynch. Along with the fire sale of Bear Stearns and the bankruptcy of Lehman Brothers, the rescue of Merrill Lynch confirmed the worst fears about the financial crisis. Before this acquisition, Bank of America had long desired a top tier investment banking business, and Merrill Lynch represented a strategic opportunity to acquire a troubled but premier franchise of significant scale.¹ As the financial markets continued to unravel after execution of the merger agreement, this golden opportunity turned into a highly risky gamble. Merrill Lynch was losing money at an astonishing rate, an event sufficient for Bank of America to consider seriously invoking the merger agreement's material adverse change clause.² The deal ultimately closed, but only after the government threatened to fire Bank of America's management and board if the company attempted to terminate the deal. The government took this coercive action to save the financial system from complete collapse. The harm to the financial system from a broken deal, officials feared, would have been unthinkable. The board's motivation is less clear. Like many classic corporate law cases, the factors influencing the board and management were complex.

This history serves as a contextualizing framework to analyze a theoretical issue in corporate governance. Corporate governance is generally considered a private activity. The business of the corporation is

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¹ Bank of America formed from the acquisition of BankAmerica by NationsBank in 1998. NationsBank was an aggressive, acquisitive bank under the leadership of Hugh McColl, whom Ken Lewis would ultimately succeed as chief executive officer ("CEO"). Before the acquisition of BankAmerica, NationsBank had sought an investment banking franchise, and following this strategy acquired in 1997 Montgomery Securities, a midsized San Francisco-based investment bank. Peter Truell, *Nationsbank Confirms a \$1.2 Billion Deal for Montgomery*, N.Y. TIMES, July 1, 1997, at D5. The acquisition of Merrill Lynch is a continuation of Bank of America's ambition in investment banking.

² See *infra* Part I (describing the events surrounding the acquisition of Merrill Lynch and the testimonies of key principals).

managed or supervised by the board of directors;³ shareholders and the government typically react to the decisions of the management and the board.⁴ But this unique episode in American business history raises important, novel questions that lie at the intersection of corporate governance and public crisis management: (1) during a public crisis, should the board have specific authority and discretion to advance the public welfare at the direct cost of the shareholder wealth? (2) if so, what is the nature and scope of its fiduciary duty?⁵ While the facts surrounding Bank of America's acquisition of Merrill Lynch are unusual, they are not *sui generis*. The analysis of these questions is important since, however infrequent, there will always be national emergencies that entangle the government and corporations in a complex relationship. Framed more broadly, these questions continue, in the context of a global financial crisis, the debate on the purpose of the corporation and the manager's duty to serve that end.⁶

This Article is written as two discrete, independently accessible topical sections. The first topical section, presented in Part I of this Article, is a case study of Bank of America's acquisition of Merrill Lynch and the impact of a flawed merger execution on the board's subsequent decisions. I provide this case study for two reasons. First, the human and economic story is inherently interesting. I construct a narrative from various factual sources, mostly congressional testimonies and U.S. Securities and Exchange Commission ("SEC") filings, and it tells a compelling tale of the historic financial crisis. This history has inherent worth and scholarly synthesis should preserve a factual account of these important events. Second, a case study provides the empirical milieu of the complexity and immediacy of the corporate decision making process and the enormity of

³ DEL. CODE ANN. tit. 8, § 141(a) (2008); MODEL BUS. CORP. ACT § 8.01(b).

⁴ See, e.g., DEL. CODE ANN. tit. § 251(c) (2008) (requiring shareholder approval for merger or consolidation); MODEL BUS. CORP. ACT § 10.03(b) (requiring shareholder approval of amendment of articles of incorporation).

⁵ Other episodes of the financial crisis of 2008 have already taught us lessons in corporate governance. Marcel Kahan and Edward Rock recently provided a case study on JPMorgan Chase's acquisition of Bear Stearns, wherein the authors concluded that the means used for the acquisition probably violated Delaware law. Marcel Kahan & Edward Rock, *How to Prevent Hard Cases from Making Bad Law: Bear Stearns, Delaware, and the Strategic Use of Comity*, 58 EMORY L.J. 713, 716-21 (2009). Additionally, Delaware courts have already begun to decide cases related to the conduct of boards and managements of financial institutions during the financial crisis. See *In re Am. Int'l Group, Inc.*, 965 A.2d 763 (Del. Ch. 2009); *In re Citigroup Inc. S'holder Derivative Litig.*, 964 A.2d 106 (Del. Ch. 2009).

⁶ The debate on corporate purpose is long running. See, e.g., Adolf A. Berle, *Corporate Powers as Powers in Trust*, 44 HARV. L. REV. 1049, 1049 (1931) (corporate agents exercise power "only for the ratable benefit of all the shareholders as their interest appears"); E. Merrick Dodd, *For Whom Are Corporate Managers Trustees?*, 45 HARV. L. REV. 1145, 1148 (1932) (a corporation "has a social service as well as a profit-making function"). Yet even now it is the "most basic and arguably the most persistent controversy in corporate law." William T. Allen et al., *The Great Takeover Debate: A Mediation on Bridging the Conceptual Divide*, 69 U. CHI. L. REV. 1067, 1071 (2002).

the stakes involved during a national crisis.⁷ Based on this factual record, I conclude that Bank of America failed to conduct proper due diligence and overpaid for Merrill Lynch, calling into serious question whether its board violated the duty of care. Unfortunately or fortunately, depending on the perspective, the board did not have a sound contractual basis to invoke the material adverse change clause in the merger agreement to terminate the merger. Irrespective of a government threat, the board cannot be held liable for failing to exercise a dubious legal option, the exercise of which would have imperiled the company through legal liability and the financial market through the injection of systemic risk.⁸

The second topical section, presented in Parts II through IV of this Article, advances a theoretical basis for fiduciary exemption during a public crisis. I make explicit a fundamental assumption running throughout this Article: that is, the circumstances examined here is where a corporation is uniquely situated to avert or mitigate a public crisis at a substantial private cost to the firm, but where the cost-benefit calculation from a societal perspective overwhelmingly weighs in favor of such action. This is the essential nature of a public necessity.⁹ We saw the possibility, but not the realization, of this situation when Bank of America appeared to be uniquely situated to prevent a further meltdown of the capital markets by assuming Merrill Lynch's breathtaking losses accruing in between signing of the merger agreement and closing. Consider, then, the counterfactual: suppose Bank of America's board did have a viable legal option to terminate the acquisition, thereby the option to forego massive financial loss at the direct cost of exacerbating a global financial crisis. Can the board harm shareholders' economic interest when the corporation is uniquely situated to promote the public good during a national crisis? One day in a different set of facts arising from a public crisis, a board may confront this Hobson's choice between maximizing shareholder profit and protecting the public good.

⁷ There are several shareholder derivative and federal securities actions involving the Bank of America-Merrill Lynch deal. *See, e.g.*, In re Bank of Am. Corp. Sec., Derivative & Employment Ret. Income Sec. Act (ERISA) Litig., 258 F.R.D. 260 (S.D.N.Y. 2009); In re Bank of Am. Corp. Stockholder Derivative Litig., Verified Consolidated Amended Derivative Complaint, C.A. NO. 4307-VCS (Del. Ch., May 8, 2009) [hereinafter "Derivative Complaint"]. *See also* In re Bank of Am. Corp. Stockholder Derivative Litig., Motion to Dismiss, C.A. NO. 4307-VCS (Del. Ch., June 19, 2009) [hereinafter "Motion to Dismiss"]. The analysis in this Article does not predict how these cases should be resolved. Important facts, such as the adequacy of disclosure, can only be established through fact-finding or admission. Rather, this episode is used as a contextualizing vehicle to discuss broader policy questions in corporate law.

⁸ *See infra* Part II.A. (discussing why Bank of America could not legally terminate the merger with Merrill Lynch under the merger agreement's material adverse effect clause).

⁹ RESTATEMENT (SECOND) OF TORTS § 196 (1965) (stating that the public necessity doctrine allows one to enter the property of another to avert an "imminent public disaster").

The Bank of America-Merrill Lynch episode serves as a contextualizing vehicle to advance a theory of public necessity exemption to fiduciary duty. A board's action to nationalize corporate governance and purpose per public necessity is authorized by Delaware law, specifically section 122(12) of the Delaware General Corporation Law ("DGCL"), which thus far has received scant attention. This Article constructs around this statute a framework for recognizing a fiduciary exemption based on the board's determination that the firm, being uniquely situated to avert or mitigate the public crisis, should provide aid. Simply stated, public necessity, a well established concept borrowed from tort law, excuses the destruction of private property (in the context here, not the destruction but the transfer of assets to other parties or causes).¹⁰ When the board perceives that the threat to the public welfare is great enough, the shareholder primacy norm can and sometimes does fail the stress test of a crisis.

Part I presents the case study of the merger and analyzes the fiduciary duty issues. Readers who are not interested in the factual details and legal issues of the Bank of America-Merrill Lynch merger episode can skip this Part without loss of essential context. Part II advances the idea of fiduciary exemption, which is justified under a theory of public necessity. Part III frames this theory in the broader context of the continuing debate on shareholder primacy and corporate purpose. The Merrill Lynch acquisition demonstrates the conditional limits of the shareholder primacy norm. Shareholder primacy is best understood as a default norm serving as a proxy for the normatively superior principle of social wealth and welfare maximization. Part IV discusses the state-federal political aspect of corporate governance and public crisis management. If state corporate law undermines national crisis management policies, this Article argues, the federal government could enact a fiduciary safe harbor; or perhaps more aggressively it could enact a limited duty to assist government authority for the boards of systemically or strategically-important corporations, such as those belonging to the financial, energy, pharmaceutical, and technology sectors, just to name a few.

I. CASE STUDY OF THE MERRILL LYNCH ACQUISITION

In 2008, three major investment banks—Bear Stearns, Lehman Brothers, and Merrill Lynch—collapsed or were acquired under distress, and these events played a large part in triggering the global financial

¹⁰ See *id.* cmt. f (stating that the public necessity privilege includes the privilege to tear down or destroy buildings, remove explosives or other dangerous articles, dig ditches, remove levees, or undertake any other acts reasonably necessary to effectuate the purpose of the privilege).

crisis.¹¹ In March, Bear Stearns had already agreed to be sold in a fire sale to JPMorgan Chase.¹² This sale was a harbinger of the worst to come. By late summer, many of the largest, most important domestic and foreign financial institutions faced extraordinary peril, including Citigroup and American International Group (“AIG”), two of the largest American financial institutions at the time.¹³ On September 15, Lehman Brothers announced its bankruptcy, and Bank of America (“the Bank”) and Merrill Lynch (“Merrill”) announced their merger.¹⁴ If the fall of Bear Stearns was the first major tremor in the financial markets, the bankruptcy of Lehman Brothers triggered a seismic change from market disturbance to market failure. The pending merger between the Bank and Merrill subsequently got caught in this tectonic shift. Like everything else affected by the market meltdown, the merger’s fate faced great uncertainty and the events leading to the ultimate closing of this landmark deal constitute a major episode of the history of Wall Street and the financial crisis of 2008.

A. *Acquisition in Crisis*

The merger proxy recounts the extraordinary circumstances under which this acquisition was struck.¹⁵ On Saturday, September 13, Ken Lewis and John Thain, the CEOs of the Bank and Merrill, respectively, met to discuss a strategic relationship.¹⁶ Thain proposed a 9.9 percent minority investment in Merrill, but Lewis wanted a whole acquisition.¹⁷ Lewis

¹¹ See generally Robert J. Rhee, *The Decline of Investment Banking: Preliminary Thoughts on the Evolution of the Industry 1996–2008*, 5 J. BUS. L. & TECH. (forthcoming 2010) (discussing the collapse of the investment banking sector). At the time, there were only five full service, independent investment banks left after the industry consolidation of the 1990s and the repeal of the Glass-Steagall Act. *Id.* The banks were Goldman Sachs, Morgan Stanley, Merrill Lynch, Lehman Brothers, and Bear Stearns. *Id.*

¹² The purchase price was about \$10 per share. See Kahan & Rock, *supra* note 5, at 716-21 (describing the circumstances surrounding the deal). A year before, Bear Stearns shares traded at \$170 per share. Andrew Ross Sorkin & Landon Thomas, Jr., *JPMorgan Acts to Buy Ailing Bear Stearns at Huge Discount*, N.Y. TIMES, Mar. 24, 2008, at A1.

¹³ See Joe Nocera, *36 Hours of Alarm and Action as Crisis Spiraled*, N.Y. TIMES, Oct. 2, 2008, at A1 (describing the crisis and the troubles of financial institutions).

¹⁴ Andrew Ross Sorkin, *Bids to Halt Financial Crisis Reshape Landscape of Wall St.*, N.Y. TIMES, Sept. 15, 2008, at A1.

¹⁵ BANK OF AM. CORP. & MERRILL LYNCH & CO., MERGER PROXY 49-51 (Nov. 3, 2008) [hereinafter “MERGER PROXY”].

¹⁶ *Id.* at 49. Lewis has been the Bank’s chief executive officer since 2001. During the period analyzed here, mainly from September 2008 to January 2009, he was also the chairman of the board. On April 29, 2009, he was replaced by Walter Massey as chairman, though he remained a board member. Press Release, Bank of Am., *Bank of America Announces Results of Annual Meeting* (Apr. 29, 2009). Thain was appointed chief executive officer of Merrill in December 2007. He resigned from Merrill shortly after the merger closed in January 2009. Julie Creswell & Louise Story, *Merrill Lynch’s leader gets the ax*, HOUSTON CHRONICLE, Jan. 23, 2009, at A1. Subsequently, Lewis also announced his early resignation. See WILLIAM D. COHAN, *HOUSE OF CARDS: A TALE OF HUBRIS AND WRETCHED EXCESS ON WALL STREET* 109 (2009).

¹⁷ MERGER PROXY, *supra* note 15, at 49.

quickly got his way, and they agreed on an acquisition. Due diligence commenced that day and continued well into Sunday night.¹⁸ During these frantic two days, the two parties negotiated the terms of the merger.¹⁹ The deal was structured as a stock exchange with Merrill shareholders getting 0.8595 shares of the Bank's stock for each share of Merrill stock.²⁰ This constituted a hefty 70 percent premium over the previous Friday's closing share prices of the two companies,²¹ and valued Merrill at a multiple of 1.8x tangible book value.²² In late Sunday afternoon, the financial advisers informed the Bank's board about the results of the due diligence and provided their fairness opinions.²³ The boards of the two banks unanimously approved the merger.²⁴ The merger agreement was signed on early Monday morning.²⁵

The loss of Bear Stearns, Lehman Brothers and Merrill—three of only five full-service, independent investment banks remaining on Wall Street at the time—in rapid succession was inconceivable only a few months before.²⁶ By the time the Merrill acquisition was announced on Monday, September 15, the stock market crash was well underway. The S&P 500 index was down 24 percent from its October 2007 historic highs.²⁷ A few weeks later, in October 2008, the equity market fell off the cliff and the S&P 500 index was down 43 percent from the year before.²⁸ The stock market crash reflected broader economic problems such as the crash of the housing market, severe disturbances in the credit markets, illiquidity contagion among financial institutions, global recession, and increasing unemployment.²⁹ The most troubling and dangerous of these factors was a liquidity crisis in the credit markets, including commercial paper, repo, and

¹⁸ *Id.* at 49-50.

¹⁹ *Id.* at 50.

²⁰ *Id.* at 5.

²¹ *Id.* at 53. On September 12, 2008, the Bank's stock price closed at \$33.74 and Merrill's stock closed at \$17.05, implying a deal value of \$29 per share of Merrill stock. *Id.* at Letter to Shareholders. Subsequently, on October 30, the Bank stock closed at \$22.78 and Merrill's stock, which by this time was closely pegged to the Bank's stock price, was \$17.78. *Id.* at 8.

²² *Bank of America Buys Merrill Lynch, Creating Unique Financial Services Firm*, Bank of America Press Release (Sept. 15, 2008), available at http://www.ml.com/?id=7695_7696_8149_88278_106886_108117.

²³ Merger Proxy, *supra* note 15, at 51.

²⁴ *Id.*

²⁵ *Id.*

²⁶ See generally Rhee, *supra* note 11 (discussing the demise of Bear Stearns, Lehman Brothers, and Merrill Lynch, and generally the problems independent investment banks confronted during the financial crisis).

²⁷ On October 9, 2007, the S&P 500 closed at 1565.15. On September 15, 2008, it closed at 1192.7. Index price information is available on <http://finance.yahoo.com>.

²⁸ On October 10, 2008, the S&P 500 closed at 899.22. On March 9, 2009, the index closed at 676.53, down 57 percent from the historic high on October 9, 2007. Index price information is available on <http://finance.yahoo.com>.

²⁹ See generally MARK ZANDI, FINANCIAL SHOCK: GLOBAL PANIC AND GOVERNMENT BAILOUTS—HOW WE GOT HERE AND WHAT MUST BE DONE TO FIX IT (FT Press 2009).

money markets that fund operating cash flow for many businesses.³⁰ Investment banks were not immune, and indeed they were especially vulnerable to a disturbance in the credit market because of their highly leveraged balance sheets.³¹ An inability to fund working capital had the potential to wreck havoc by impairing the flow of credit even in healthy, nonfinancial sectors of the economy.³² According to Ben Bernanke, a prominent scholar of the Great Depression and current Chairman of the Federal Reserve, “the financial shocks that hit the global economy in September and October were the worst since the 1930s, and they helped push the global economy into the deepest recession since World War II.”³³ This crisis prompted the federal government to take unprecedented intervention in the market.

On October 3, 2008, President George W. Bush signed the Emergency Economic Stabilization Act of 2008 into law.³⁴ This centerpiece legislation of the financial crisis authorized the Troubled Asset Relief Program (“TARP”), a \$700 billion fund available to the U.S. Treasury Department (“the Treasury”) to buy troubled assets from financial institutions.³⁵ Shortly thereafter, the Treasury used TARP to inject \$125 billion in capital in the form of preferred shares and warrants into nine leading financial institutions, including the Bank and Merrill.³⁶ With respect

³⁰ Conrad de Aenlle, *It Couldn't Get Worse, But It Did*, N.Y. TIMES, Oct. 12, 2008 at BU19 (noting that credit markets were seizing up and investors were withdrawing money from the commercial paper market). See also Carter Dougherty & Katrin Bennhold, *Credit Squeeze Takes Hold in Europe*, N.Y. TIMES, Oct. 11, 2008, available at <http://www.nytimes.com/2008/10/11/business/worldbusiness/11crunch.html>.

³¹ Rhee, *supra* note 11.

³² *Id.*

³³ *Semiannual Monetary Policy Report to the Congress Before the H. Comm. Financial Servs.*, 111th Congr. (July 21, 2009) (statement of Ben S. Bernanke, Chairman, Board of Governors for the Fed. Reserve System) [hereinafter “Bernanke Testimony of July 21, 2009”]. Bernanke was a professor of economics at Princeton University before his appointment as chairman of the Federal Reserve. He testified that without the massive government intervention the economy would probably have collapsed. He provided this chilling assessment:

I think you would've had a very good chance of a collapse of the credit system. Even what we did see, with perhaps the failure of Lehman was for example, commercial paper rates shot up and availability declined. Many other markets were severely disrupted, including corporate bond markets. So even with the rescue and even with the stabilization that we achieved in October, there was a severe increase in stress in the financial markets. My belief is that if we had not had the money to address the global banking crisis in October we might very well have had a collapse of the global banking system that would've created a huge problem in financial markets, and in the broad economy that might've lasted many years.

Id.

³⁴ 12 U.S.C. §§ 5201 et seq. (2008).

³⁵ *Id.* § 5225.

³⁶ On October 28, 2008, these capital injections were made: Bank of America (\$15 billion), Bank of New York Mellon (\$3 billion), Citigroup (\$25 billion), Goldman Sachs (\$10 billion), JPMorgan Chase (\$25 billion), Morgan Stanley (\$10 billion), State Street (\$2 billion), Wells Fargo (\$25 billion), Merrill Lynch (\$10 billion). Troubled Asset Relief Program Transaction Report (Nov. 17, 2008), available at

to the Bank, the federal government purchased 600,000 shares of nonvoting preferred stock and warrants to purchase over 73 million shares of common stock.³⁷ However, the government did not acquire substantial voting control over the Bank.³⁸

On November 3, 2008, the Bank issued the merger proxy with information dated as of October 30.³⁹ The proxy identified as a risk factor the possibility that changing market conditions may ultimately affect the deal economics.⁴⁰ Among other things, it warned that changes in the operations and prospects, general market and economic conditions “may significantly alter the value of Bank of America or Merrill Lynch or the prices of shares of Bank of America common stock or Merrill Lynch common stock by the time the merger is completed.”⁴¹

On November 5, 2008, Merrill reported in its third quarter 10-Q an \$8.25 billion pretax loss from continuing operations.⁴² The 10-Q disclosed difficult market conditions that could adversely affect financial results.⁴³ A day later, the Bank also issued its 10-Q, which provided similar warnings, including “Merrill Lynch’s ability to mitigate its risk by selling or hedging its exposures is also limited by the market environment, and its future results may continue to be materially impacted by the valuation adjustments applied to these positions.”⁴⁴ These disclosures simply stated the obvious. The common experience of all investors in the equity markets, including shareholders of both Merrill and the Bank, would have suggested that the financial markets were highly volatile.

<http://www.financialstability.gov/latest/reportsanddocs.html>. Preferred stock is equity capital that has priority over common stock, and is usually characterized by a priority on dividends and assets upon liquidation relative to common stock. BLACK’S LAW DICTIONARY 1553 (9th ed. 2009). Warrants are stock options issued by the company. *Id.* at 1555.

³⁷ Bank of Am. Corp., Current Report (Form 8-K) Item 1.01 & A-7 (Oct. 31, 2008).

³⁸ The 73 million shares would constitute a small percentage of shares. *See* Bank of Am. Corp., Annual Report (Form 10-K), at 2 (over 5 billion shares of common stock issued and outstanding as of December 31, 2008).

³⁹ MERGER PROXY, *supra* note 15.

⁴⁰ *Id.* at 23-26.

⁴¹ *Id.* at 24.

⁴² Merrill Lynch & Co., Quarterly Report (Form 10-Q), at 4 (Nov. 5, 2008).

⁴³ Merrill cautioned that “[t]he challenging conditions that existed in the global financial markets during the first half of the year continued during the third quarter of 2008”; that this “adverse market environment [had] intensified towards the end of the quarter, particularly in September, and was characterized by increased illiquidity in the credit markets, wider credit spreads . . . and concerns about corporate earnings and the solvency of many financial institutions”; that “[t]urbulent market conditions in the short and medium-term will continue to have an adverse impact on our core businesses”; and that “our businesses must contend with extreme volatility and continued deleveraging in the market.” *Id.* at 82-83.

⁴⁴ Bank of America Co., Quarterly Report (Form 10-Q), at 175-77 (Nov. 6, 2008). The 10-Q also disclosed: that “difficult market conditions have adversely affected our industry”; that there has been “significant write-downs of asset values by financial institutions”; and that “lack of confidence in the financial markets has adversely affected our business, financial condition and results of operations.” *Id.*

In late November 2008, the Federal Reserve approved the merger under the Bank Holding Act,⁴⁵ and on December 5, the shareholders of the Bank and Merrill voted in favor of the deal.⁴⁶ Thereafter, in early December while the acquisition was still pending, Lewis learned that Merrill was accruing enormous losses from its investments in toxic assets.⁴⁷ On December 14, he advised the board of this development.⁴⁸ This unexpected news gave the Bank serious pause about closing the acquisition. Lewis considered exercising the merger agreement's material adverse change clause ("MAC"), which if legally exercised would have allowed the company to terminate the deal based on a material change in events after the signing of the merger agreement but before closing.⁴⁹

On December 17, Lewis told Henry Paulson, then Treasury Secretary, and Bernanke that the Bank was considering invoking the MAC.⁵⁰ Lewis told them that the estimated losses at Merrill were \$12 billion for the fourth quarter of 2008, a staggering \$3 billion increase from previous estimate of just six days before.⁵¹ These losses were stunning.⁵² Paulson and Bernanke strongly advised Lewis against terminating the Merrill deal because they believed that this would lead to adverse consequences, including the insolvency of Merrill, litigation against the Bank, and the injection of more systemic risk and uncertainty into the capital market.⁵³ The Federal Reserve believed that if the deal fell through, Merrill could not have survived as an independent firm and would have collapsed like Bear Stearns and Lehman Brothers.⁵⁴ It feared that Merrill's

⁴⁵ *Bank Of America And Merrill Lynch: How Did A Private Deal Turn Into A Federal Bailout? Part II, Before the H. Comm. on Oversight and Government Reform*, 111th Congr. (June 25, 2009) (statement of Ben S. Bernanke, Chairman, Board of Governors for the Fed. Reserve System).

⁴⁶ *Id.*

⁴⁷ *In re Executive Compensation Investigation: Bank of America-Merrill Lynch Before the Attorney General of the State of New York* 11-12 (Feb. 26, 2009) (examination of Kenneth Lee Lewis, Chief Executive Officer, Bank of America) (identifying the period as December 5 through 14), available at http://www.oag.state.ny.us/media_center/2009/apr/pdfs/Exhibit%20A%20to%204.23.09%20letter.pdf [hereinafter "Lewis Testimony Before the New York Attorney General"].

⁴⁸ *Id.* at 13.

⁴⁹ *Id.* at 37.

⁵⁰ Bernanke was appointed to a four-year term as the chairman of the Board of Governors of the Federal Reserve on February 1, 2006. Paulson was the Treasury Secretary from July 2006 to January 2009 under the Bush Administration. Before this, he was the CEO of Goldman Sachs.

⁵¹ Lewis Testimony Before the New York Attorney General, *supra* note 47, at 40.

⁵² In an e-mail, Paulson described the losses as "breath-taking." Michael R. Crittenden, *Fed Emails Bash BofA Chief in Tussle over Merrill Deal*, WALL ST. J., June 11, 2009, at A1. Another internal e-mail from a senior vice president at the Federal Reserve reads, "Merrill is really scary and ugly." Paul Tharp, *Lewis Ticks 'Em Off: Jittery BofA Head Keeps Silence Before Congress*, N.Y. POST, June 12, 2009, at 31.

⁵³ See *infra* Part I.B. (discussing the roles of both Paulson and Bernanke).

⁵⁴ Merrill's deterioration was significant, and "all but ensure[d] that the firm could not survive as a stand-alone entity without raising substantial new capital (and/or government support) that is unlikely to be available given the uncertainty about its prospects," Phil Mattingly, *Did Bank of America Get Stong-*

collapse would have continued a domino effect to other systemically-important financial institutions.⁵⁵

On December 21, Lewis talked to Paulson again about exercising the MAC. During this crucial conversation, Paulson threatened to fire the Bank's board and management if the company sought to terminate or renegotiate the merger.⁵⁶ Such termination or renegotiation of the deal would have jeopardized the merger or delayed its closing.⁵⁷ Lewis took this message back to the board.⁵⁸

On December 22, the board met to discuss whether it was still in favor of proceeding with the Merrill acquisition.⁵⁹ The board minutes show that Lewis in his CEO capacity reported to the board these key points of the call with Paulson:

(i) first and foremost, the Treasury and Fed are unified in their view that the failure of the Corporation to complete the acquisition of Merrill Lynch would result in systemic risk to the financial services system in America and would have adverse consequences for the Corporation;

(ii) second, the Treasury and Fed stated strongly that were the Corporation to invoke the material adverse change ("MAC") clause in the merger agreement with Merrill Lynch and fail to close the transaction, *the Treasury and Fed would remove the Board and management of the Corporation*;

(iii) third, the Treasury and Fed have confirmed that they will provide assistance to the Corporation to restore capital and to protect the Corporation against adverse impact of certain Merrill Lynch assets; and

(iv) fourth, the Fed and Treasury stated that the investment and asset protection promised could not be provided or completed by scheduled closing date of the merger, January 1, 2009; that the merger should close on schedule, and that the Corporation can rely on the Fed and Treasury to complete and deliver the promised support by January 20, 2009, the date scheduled for the release of earnings by the Corporation.⁶⁰

At the board meeting, Lewis communicated the management's recommendation not to invoke the MAC.⁶¹ This recommendation was based on, among other things, "instruction from the Fed and Treasury not to exercise the MAC" and the government's verbal assurance of financial assistance through TARP to support the Bank and provide some downside

Armed in Merrill Deal?, C.Q. TODAY, June 10, 2009, available at <http://www.cqpolitics.com/wmspage.cfm?docID=news-000003140207>.

⁵⁵ *Id.*

⁵⁶ Lewis Testimony Before the New York Attorney General, *supra* note 47, at 52.

⁵⁷ *Id.*

⁵⁸ *Id.*

⁵⁹ *Id.* at 53.

⁶⁰ Minutes of Special Meeting of Board of Directors of Bank of America Corporation, at 2 (Dec. 22, 2008) (emphasis added) [hereinafter "Board Minutes of Dec. 22, 2008"], available at http://www.oag.state.ny.us/media_center/2009/apr/pdfs/Exhibit%20B%20to%204.23.09%20letter.pdf.

⁶¹ *Id.* at 2-3.

protection against declining asset values.⁶² One board member, called to testify before Congress, recalled the following from the board meeting:

[Lewis] expressed the fact that the government thought it would be a major mistake for us to walk away. They thought it would be very dangerous systemically and very dangerous and not positive at all for the Bank of America. . . . He expressed the sentiment and there was another session later in the month, that the government would provide financing. There was nothing in writing, but it was from very senior officials of the government that one would believe would follow through. The details were not reviewed with the board. . . . *The issue was relatively clear to me. In a perfect world, it would have been better to walk away.*⁶³

With respect to the board's inability or disinclination to "walk away" from Merrill, this board member "express[ed] remorse for all shareholders" who took the financial loss.⁶⁴

Based on the considerations presented to the board, it decided not to invoke the MAC, renegotiate the merger price with Merrill, or inform shareholders of Merrill's losses ahead of planned disclosure.⁶⁵ The minutes purport to document the basis for this decision:

Discussion ensued, with the Board clarifying that [it] was not persuaded or influenced by the statement by the federal regulators that the Board and management would be removed by the federal regulators if the Corporation were to exercise the MAC clause and fail to complete the acquisition of Merrill Lynch. The Board concurred it would reach a decision that it deemed in the best interest of the Corporation and its shareholders without regard to this representation by the federal regulators.⁶⁶

While self-consciously professing its independence, the board made a considered decision (the deliberate decision not to invoke a MAC), and thereby decided to close the Merrill merger as planned.⁶⁷

On January 1, 2009, ten days after the Bank's board meeting, the acquisition of Merrill closed.⁶⁸ Other than the original merger proxy, there

⁶² *Id.*

⁶³ *Bank of America and Merrill Lynch: How Did A Private Deal Turn Into A Federal Bailout? Before the H. Comm. on Oversight and Government Reform*, 111th Cong. 16-17 (Nov. 17, 2009) (statements of Brian Moynihan, President of Consumer and Small Business Banking, Bank of Am., Charles Gifford, Member, Bank of Am. Bd. of Dirs., Thomas May, Member, Bank of Am. Bd. of Dirs., and Timothy Mayopolous, Former General Counsel, Bank of Am.) (emphasis added) [hereinafter "Gifford et al. Testimony"]

⁶⁴ *Id.* at 15. This testimony sought to explain an email in which the board member wrote, "Unfortunately, it's [sic] also screw[s] the shareholders." *Id.* While the language in this private email is crude, it provides an unvarnished assessment of the effect on shareholders.

⁶⁵ Board Minutes of Dec. 22, 2008, *supra* note 60, at 2-3. The minutes provide: "Mr. Lewis stated the purpose of the special meeting is to insure that the Board is in accord with management's recommendation to complete the acquisition of Merrill Lynch & Co., Inc. ('Merrill Lynch'), as scheduled on January 1, 2009, pursuant to the [merger agreement] . . . after due consideration of the undertakings and admonishments of the federal regulators." *Id.* at 1.

⁶⁶ *Id.* at 3.

⁶⁷ *Id.*

was no supplemental disclosure to shareholders on Merrill's deteriorating financial condition before closing.⁶⁹

On January 16, the Bank disclosed that losses from Merrill were over \$15 billion for the fourth quarter ended December 31, 2008.⁷⁰ This was over \$3 billion more than the \$12 billion estimate Lewis had learned in mid-December, but the information had not been disclosed to shareholders.⁷¹ The Bank also disclosed that it would receive an additional \$20 billion in TARP funds (an investment of preferred stock with an 8 percent dividend), and would receive insurance protection from market exposure of \$118 billion in assets, primarily exposure from Merrill's portfolio.⁷²

B. *Reflections of the Principal Actors*

Like the fire sale of Bear Stearns and the bankruptcy of Lehman Brothers, the acquisition of Merrill was a key event in the history of Wall Street and the financial crisis.⁷³ This deal also became controversial.⁷⁴ Without the involvement of Paulson and Bernanke, there was a possibility that the Bank would have invoked the MAC and thereby compromised or complicated the deal. Controversy surrounding the government's role in the merger ensued when Lewis was called to testify before the New York Attorney General's office.⁷⁵

Lewis testified that the federal government played a coercive role in the merger.⁷⁶ The government disapproved of terminating the deal or

⁶⁸ Press Release, Bank of Am. Corp., Bank of America Completes Merrill Lynch Purchase (Jan. 1, 2009). Based on the stock price, the deal closed at a value of \$29.1 billion. Bank of Am. Corp., Quarterly Report (Form 10-Q), at 9 (May 7, 2009).

⁶⁹ See *infra* note 86 and accompanying text.

⁷⁰ Bank of Am. Corp., Current Report (Form 8-K), at 2 (Jan. 16, 2009).

⁷¹ See *supra* note 47 and accompanying text.

⁷² Bank of Am. Corp., Current Report (Form 8-K), at 2 (Jan. 16, 2009).

⁷³ The demise of these three firms marks the end of Wall Street's era of independent investment banks. During the 1990s, leading up to the repeal of the Glass-Steagall Act, independent investment banks had been acquired by large commercial banks. See generally ALAN D. MORRISON & WILLIAM J. WILHELM, JR., INVESTMENT BANKING: INSTITUTIONS, POLITICS, AND LAW (2007) (discussing the business of investment banking and historical industry trends). Each of these firms was acquired by a commercial bank: Bear Stearns by JPMorgan Chase, investment banking assets of Lehman Brothers by Barclays, and Merrill Lynch by Bank of America. Today, only Goldman Sachs and Morgan Stanley remain independent, pure investment banks even though they converted to bank holding companies in 2008. Goldman Sachs Group, Inc., Annual Report (Form 10-K), at 1-2 (Nov. 28, 2008); Morgan Stanley & Co., Annual Report (Form 10-K), at 1 (Nov. 30, 2008).

⁷⁴ Louise Story & Jo Becker, *Bank Chief Tells of U.S. Pressure to Buy Merrill Lynch*, N.Y. TIMES, June 11, 2009, at B1; Zachary Kouwe, *Paulson Expected to Face Hard Questioning on Merrill Deal*, N.Y. TIMES, June 15, 2009, at B3; Edmund L. Andrews, *Bernanke Defends His Role in Merrill Sale*, N.Y. TIMES, June 25, 2009, at B1.

⁷⁵ The attorney general's office was investigating agreements on executive bonuses associated with the merger. See *infra* note 110.

⁷⁶ See Lewis Testimony before the New York Attorney General, *supra* note 47, at 52).

delaying the closing to renegotiate price.⁷⁷ Paulson threatened that if the Bank backed out of the deal with Merrill the government “could” or “would” fire the management and board.⁷⁸ Lewis believed that the government had the power to carry out its threat.⁷⁹ Upon being threatened, he suggested that the Bank and government “deescalate this for a while.”⁸⁰ Absent the federal government’s threat, Lewis wanted to invoke the MAC, but felt he had no choice in the matter.⁸¹ He thought that “it was in the best interest to go forward as had been instructed” because “if [the government] had felt that strongly, then that should be a strong consideration for us to take into account.”⁸² As far as shareholders, their interest could not be isolated from systemic risk considerations; the best interests of the country and shareholders were intertwined.⁸³ While going forward with the deal meant a short-term loss for shareholders, Merrill still filled strategic necessities and over the long term would still benefit shareholders.⁸⁴

After this testimony, the New York Attorney General’s office wrote to Congress and informed it of questions “about the transparency of the TARP program, as well as about corporate governance and disclosure practices at Bank of America.”⁸⁵ This prompted the congressional testimonies of Lewis, Bernanke, and Paulson.⁸⁶ While their testimonies differ in shades, they largely support Lewis’s account of events.

Lewis reaffirmed his prior testimony that Paulson’s threat did not impress him so much as the seriousness of a situation that could have led the government to threaten a company and CEO in good standing.⁸⁷ The exercise of the MAC would have posed risks, including litigation risk and the risk of losing government support during a financial crisis.⁸⁸ According

⁷⁷ Bank of Am., Current Report (Form 8-K), at 90-91 (Jan. 16, 2009).

⁷⁸ *Id.* at 52.

⁷⁹ *Id.* at 54.

⁸⁰ *Id.* at 52.

⁸¹ *Id.* at 58, 96.

⁸² *Id.* at 97, 151.

⁸³ Bank of Am., Current Report (Form 8-K), at 82-83 (Jan. 16, 2009).

⁸⁴ *Id.* at 86.

⁸⁵ Letter from Andrew Cuomo, Att’y Gen., State of N.Y., to Sen. Christopher Dodd, Chairman, Sen. Comm. on Banking, Housing, & Urban Affairs; Rep. Barney Frank, Chairman, H. Fin. Servs. Comm.; Mary L. Schapiro, Chair, Sec. Exch. Comm’n; and Elizabeth Warren, Chair, Cong. Oversight Panel (Apr. 23, 2009).

⁸⁶ *Bank of America and Merrill Lynch: How Did A Private Deal Turn Into A Federal Bailout? Before the H. Comm. on Oversight and Government Reform*, 111th Cong. (June 11, 2009) (testimony of Kenneth Lee Lewis, Chief Executive Officer, Bank of America), (Morning Session, June 11, 2009) [hereinafter “Lewis Testimony Part I”]; (testimony of Lewis) (Afternoon Session, June 11, 2009), at 2 [“Lewis Testimony Part II”]; (testimony of Ben S. Bernanke, Chairman, Fed. Reserve Board) (June 25, 2009) [hereinafter “Bernanke Testimony”]; (testimony of Henry Paulson, former Secretary of the Treasury) (July 16, 2009) [hereinafter “Paulson Testimony”]; (prepared testimony of Paulson (July 16, 2009), at 3 [hereinafter “Paulson Prepared Testimony”].

⁸⁷ Lewis Testimony before the New York Attorney General, *supra* note 86, at 8, 19.

⁸⁸ *Id.* at 30.

to Lewis, closing the deal was the better option.⁸⁹ He added that the “target was to [complete the merger] so that we didn’t damage the economy anymore.”⁹⁰ The Merrill acquisition was “in the best interests of the financial system, the economy and the country” because the collapse of Merrill, “on the heels of Lehman’s failure, could have caused systemic havoc or necessitated an AIG-style government bailout.”⁹¹ Shareholder interest was inextricably intertwined with the financial system; harm to the financial system would have inflicted harm to the company as well.⁹² Furthermore, the acquisition had strategic value and promised long-term reward.⁹³ Merrill’s losses would push the profitability of the deal toward a longer time horizon and affected short-term shareholder value.⁹⁴ As for disclosure, the government did not ask the board to withhold any disclosure to shareholders.⁹⁵ Merrill’s losses were not disclosed before the deal closed because there was no agreement on its timing.⁹⁶

For his part, Paulson confirmed that he threatened to fire the board and management.⁹⁷ He testified that the exercise of the MAC would have demonstrated “a colossal lack of judgment and would jeopardize Bank of America, Merrill Lynch, and the financial system.”⁹⁸ He and Bernanke believed that invoking a MAC would have been detrimental to both the Bank and the financial system.⁹⁹ Lawyers at the Federal Reserve believed that the Bank did not have sound legal basis to exercise the MAC.¹⁰⁰ The market would have viewed the legal merit of invoking the MAC as “quite low” and both Merrill and the Bank would have been adversely affected by

⁸⁹ *Id.* at 7, 9.

⁹⁰ *Id.* at 33. *See also* Paulson Testimony, *supra* note 86, at 18 (confirming Lewis’s recollection).

⁹¹ Lewis Testimony Before the New York Attorney General, *supra* note 86, at 6-7. Lewis was criticized in the media for putting the interest of the country over that of shareholders. *See* Sinclair Stewart, *The Merrill Takeover: Patriotic Bumbling? Bank of America’s CEO Cites Loyalty to Country, After Huge Losses, Investors Wonder if His Motive was Misguided*, GLOBE & MAIL, Jan. 17, 2009, at B4.

⁹² Lewis Testimony Before the New York Attorney General, *supra* note 86, at 12.

⁹³ *Id.* at 7, 31.

⁹⁴ *Id.* at 23, 31.

⁹⁵ Lewis Testimony Part II, *supra* note 86, at 2.

⁹⁶ Lewis Testimony before the New York Attorney General, *supra* note 86, at 33-34.

⁹⁷ Paulson Testimony, *supra* note 86, at 21-22; Paulson Prepared Testimony, *supra* note 86, at 3. With respect to Bernanke’s role, he testified that, “I did not threaten him” and “I didn’t tie it directly to replacing him or the board.” Bernanke Testimony, *supra* note 86, at 47, 53. Nor did he instruct Paulson to communicate the threat. *Id.* at 14; Paulson Prepared Testimony, *supra* note 86, at 5. In his memoir, Paulson wrote of the incident: “I got back to Ken later and again emphasized to him that the government would not let any systemically important institution fail; that exercising the MAC would show a colossal lack of judgment by BofA; that such an action would jeopardize his bank, Merrill Lynch, and the entire financial system; and that under such circumstances, the Fed, as BofA’s regulator, could take extreme measures, including the removal of management and the board.” HENRY PAULSON, JR., ON THE BRINK: INSIDE THE RACE TO STOP THE COLLAPSE OF THE GLOBAL FINANCIAL SYSTEM 429-30 (2010).

⁹⁸ Paulson Prepared Testimony, *supra* note 86, at 4.

⁹⁹ Bernanke Testimony, *supra* note 86, at 17, 31, 51; Paulson Prepared Testimony, *supra* note 86, at 3.

¹⁰⁰ Paulson Prepared Testimony, *supra* note 86, at 3.

the possibility of detrimental litigation.¹⁰¹ In justifying his threat, Paulson added that “it’s a pretty logical conclusion that maybe even the regulator would be irresponsible . . . if they didn’t hold [the Bank and Merrill] accountable.”¹⁰² This statement implies that the board and management of the Bank would have been replaced if they had proceeded with an ill-advised legal stratagem to abort the merger.

Bernanke and Paulson distinguished their obligations as regulators from the board’s duty to shareholders. They testified that SEC disclosure obligations were the company’s responsibility.¹⁰³ The government’s disclosure obligation is to the public, set forth in TARP, which the government satisfied.¹⁰⁴ Bank supervisory practice did not permit a regulator to impose an obligation on a financial institution to financially injure itself for the public interest.¹⁰⁵ Conversely, regulators did not have a duty to protect the pecuniary interest of shareholders or bondholders vis-à-vis the soundness of the financial institution and the markets or more broadly the public welfare. In administering TARP, the Treasury Secretary must take into consideration various factors including the protection of taxpayers, stability of the financial markets, long-term viability of financial institutions, and efficient use of funds.¹⁰⁶

Bernanke and Paulson echoed Lewis’s assessment of the public role the Bank served in stabilizing the financial market: Merrill would have collapsed without a takeover; a renegotiation of the purchase price would have created uncertainty in the market; the failure of Merrill, which was bigger than Lehman Brothers, would have destabilized the financial market even further.¹⁰⁷

On the issue of whether the Bank’s shareholders were forced “to take a bullet,” Paulson testified:

[S]ome have opined that government officials involved in examining the Bank of America Merrill Lynch merger—myself included—allowed concerns about systemic risk to our nation’s financial system to outweigh concerns about potential harm to Bank of America and its shareholders. That simply did not happen. In my view, and the view of the numerous government officials working on the matter, the interests of the nation and Bank of America were aligned with respect to the closing of the Merrill Lynch transaction. An attempt by Bank of America to break its contract to acquire Merrill Lynch would have threatened the stability of our entire financial system *and* the viability of both Bank of America and Merrill Lynch.¹⁰⁸

¹⁰¹ *Id.* at 11.

¹⁰² Paulson Testimony, *supra* note 86, at 37.

¹⁰³ *Id.* at 25.

¹⁰⁴ Bernanke Testimony, *supra* note 86, at 3, 36-37.

¹⁰⁵ *Id.* at 16.

¹⁰⁶ Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, 122 Stat. 37.

¹⁰⁷ Bernanke Testimony, *supra* note 86, at 34, 50; Paulson Prepared Testimony, *supra* note 86, at 3.

¹⁰⁸ Paulson Prepared Testimony, *supra* note 86, at 3.

Bernanke added: “I think it was a very successful transaction. It helped stabilize the financial markets. It put two companies back on a healthy path. It protected our economy. And it was a good deal for taxpayers. . . . And it achieved public objectives that were very important.”¹⁰⁹ Thus, both Paulson and Bernanke forcefully defended their conduct and argued that government action produced positive effects on the two companies and the financial markets.

C. *Merger Execution and Fiduciary Duty*

As a preliminary matter, the Bank poorly executed the Merrill acquisition. The disclosure and procedural issues stand out: were the board and the shareholders properly informed by the management, advisers, and the merger proxy, respectively, when each approved the acquisition? Only findings of facts or admissions on the extent of knowable information and the scienter at the time can resolve these issues. I comment no further on the disclosure and federal securities issues.¹¹⁰ I assume that, as Lewis’s testimony suggests, the Bank learned of the accelerating pace of Merrill losses after the shareholder vote on December 5, 2008, and that disclosure of material facts up to this point, including the merger proxy, containing financial information dated October 30, was proper and thus the shareholder vote was not tainted by faulty disclosure. Trial on these issues may later prove these assumptions wrong, but the disclosure issue is tangential to the thesis of this Article, which advances a theory of fiduciary exemption and a broader comment on shareholder primacy.

The duty of care with respect to the merger execution on September 13-15 is also tangential. This issue is relevant here only insofar

¹⁰⁹ Bernanke Testimony, *supra* note 86, at 21.

¹¹⁰ As of the writing of this Article, issues pertaining to the disclosure issue are rapidly developing. On August 3, 2009, the Bank settled for \$33 million with the SEC on charges concerning misleading and false disclosure to shareholders with respect to executive bonuses paid out as a part of the Merrill acquisition. Zachery Kouwe, *Bank of America Settles S.E.C. Suit Over Merrill Deal*, N.Y. TIMES, Aug. 3, 2009, at B1. However, the federal district court disapproved the settlement and ordered the case for trial. *Sec. Exch. Comm’n v. Bank of Am. Corp.*, 653 F. Supp. 2d 507 (S.D.N.Y. 2009). The opinion is notable for the tone of the court’s indignation: “Overall, indeed, the parties’ submissions, when carefully read, leave the distinct impression that the proposed Consent Judgment was a contrivance designed to provide the S.E.C. with the facade of enforcement and the management of the Bank with a quick resolution of an embarrassing inquiry—all at the expense of the sole alleged victims, the shareholders.” *Id.* at 510. Subsequently, the Bank and the SEC revised the proposed settlement to \$150 million, but in a hearing the federal court suggested that this amount may still be too small and proposed a range of \$300 to \$600 million. Louise Story, *Judge Questions Bank of America’s New Deal with S.E.C.*, N.Y. TIMES, Feb. 8, 2010. The shareholder derivative lawsuit in the Delaware Chancery Court alleges a breach of fiduciary duty based on a failure to inform shareholders of Merrill’s losses. Derivative Complaint, *supra* note 7, at ¶¶ 11-16. Moreover, on February 4, 2010, the New York Attorney General filed civil fraud charges against the Bank, Lewis and Joseph Price (the Bank’s chief financial officer at the time). Louise Story, *Cuomo Sues Bank of America, Even as It Settles with S.E.C.*, N.Y. TIMES, Feb. 4, 2010. See *Cuomo v. Bank of Am. Corp. et al.*, Complaint (Sup. Ct. N.Y., Feb. 4, 2010).

as the quality of the due diligence may explain in part the board's later consideration to terminate the deal, the event leading to the government's involvement in the Bank's corporate governance. To develop this thought, I assess the duty of care issue.

A board's decision must be informed and made in good faith. This requirement calls into question the board's initial approval of the merger. The Delaware standard for the duty of care is gross negligence.¹¹¹ With an informed decision based on proper due diligence, the business judgment rule would protect the board's decision to approve the merger.¹¹² The decision of the Bank's board constituted a high-risk strategic decision, and Delaware courts would not engage in ex post analysis of an informed, good faith judgment made under uncertainty even if the merger was poorly executed or the outcome was poor.¹¹³

However, the board's decision was not an informed one because the procedure used to approve the Merrill acquisition was highly flawed. The facts in the seminal decision, *Smith v. Van Gorkom*,¹¹⁴ are informative. There, the target company was undergoing a sale process.¹¹⁵ The board was found to have violated the duty of care based on several factors: a failure to adequately inform itself of vital aspects of the deal, including the intrinsic value of the company; approving the sale after only two hours of consideration; and failure to read the deal documents because they were unavailable at the board meeting.¹¹⁶ The Delaware Supreme Court held that these facts were sufficient to prove the board's gross negligence.¹¹⁷

The publicly available facts suggest that the Bank's board was grossly negligent in the process used to approve the Merrill acquisition. Indeed, the board's negligence is qualitatively worse than the simple negligence in *Van Gorkom*.¹¹⁸ The obvious problem is the quality of the due diligence. The merger agreement states that due diligence on the deal was

¹¹¹ *Smith v. Van Gorkom*, 488 A.2d 858, 873 (Del. 1985).

¹¹² See *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984) (noting that the business judgment rule protects "directors of a corporation [who] 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.>").

¹¹³ See *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959, 967 (Del. Ch. 1996) (reasoning that upon the proper application of the business judgment rule there is no ex post review of actions that were "substantively wrong, or degrees of wrong extending through 'stupid' to 'egregious' or 'irrational' . . .").

¹¹⁴ 488 A.2d 858 (Del. 1985); see also *Gantler v. Stephens*, 965 A.2d 695, 713 n.54 (Del. 2009) (holding that shareholder ratification subjects "the challenged director action to business judgment review, as opposed to 'extinguishing' the claim altogether . . .").

¹¹⁵ *Van Gorkom*, 488 A.2d at 873.

¹¹⁶ *Id.* at 874.

¹¹⁷ *Id.* at 884.

¹¹⁸ See William T. Allen et al., *Function Over Form: A Reassessment of Standards of Review in Delaware Corporation Law*, 56 BUS. LAW. 1287, 1300 (2001) (arguing that the facts in *Van Gorkom* may have shown negligence but not gross negligence); Sean Griffith, *Good Faith Business Judgment: A Theory of Rhetoric in Corporate Law Jurisprudence*, 55 DUKE L.J. 1, 14 (2005) ("The majority of commentators now agree that on the merits the evidence does not support the conclusion that the Trans Union board had been grossly negligent.>").

conducted over a period of a day and a half (Saturday afternoon to Sunday evening), about thirty hours.¹¹⁹ Such a short time period could not have been sufficient to conduct adequate due diligence on a business as big and complex as Merrill Lynch in normal times, let alone in a time of extreme market volatility and crisis. Is it plausible that the Bank adequately reviewed within a matter of a few hours asset quality, liabilities, trading positions, risk management structures, values at risk, along with many other facets of the business? The answer is certainly not. The two companies probably engaged armies of internal and external lawyers, accountants, and bankers, and there was probably frantic activity during the weekend, creating an illusion of due diligence. But raw manpower can only do so much in a short time period; reasonable due diligence entails contemplation and assimilation of information learned.¹²⁰

The choice of financial advisers, no small decision, is also informative. Merrill used its own investment bankers who delivered the fairness opinion.¹²¹ The Bank hired two financial advisers who delivered fairness opinions: J.C. Flowers & Co., a private equity firm, and Fox-Pitt Kelton Cochran Caronia Waller (“FPK”), a boutique investment bank specializing in financial institutions.¹²² A deal like the merger of the Bank and Merrill would be a landmark transaction on Wall Street with huge investment banking fees (J.C. Flowers and FPK received a total of \$20 million in fees).¹²³ The advisory work on these kinds of deals are usually handled by top-tier investment banking firms, such as Goldman Sachs, Morgan Stanley, UBS Warburg, Credit Suisse First Boston, JPMorgan Chase, or other comparable firms. Why use one’s own investment bankers as Merrill did, and a private equity firm and a boutique investment bank as the Bank did for such a large complex deal?

One can speculate on several plausible explanations. J.C. Flowers had experience in restructuring of financial institutions. It was involved in attempting to rescue Bear Stearns only a few months before.¹²⁴ Because it is

¹¹⁹ This time is calculated from the time Lewis and Thain discussed a merger (Saturday, 2:30 p.m.) to the time of the announcement of the deal (Sunday, 9:23 p.m.), less one hour for lag time in organizing due diligence and other down time. Derivative Complaint, *supra* note 7, at ¶¶ 64, 71.

¹²⁰ I draw from my own experience of conducting due diligence as an investment banker on complex, multi-billion dollar potential acquisition of an investment bank in 2000. My recollection was that approximately 70 people were involved to varying degrees in the due diligence, which took several weeks to complete.

¹²¹ MERGER PROXY, *supra* note 15, at Appendix E. Query how objective this fairness opinion could have been given the management’s and board’s support of the deal.

¹²² *Id.* at Appendices C & D. I note that I was a vice president of investment banking at FPK, where I worked from 1999 to 2001. At that time, it was a wholly-owned subsidiary of Swiss Reinsurance. Prior to this, I was also an M&A banker at UBS Warburg.

¹²³ *Id.* at 68.

¹²⁴ COHAN, *supra* note 16, at 85-88 (2009). J.C. Flowers was also involved in the turnaround of Japan’s Long Term Credit Bank. *Id.* at 85.

a private equity firm, it did not compete with Merrill or the Bank on capital markets and trading activities.¹²⁵ Both firms may have been concerned about competitors gaining intelligence on their assets and liabilities and trading book, which may have had enormous informational value during unprecedented market turmoil. This is not to impugn the honesty or professionalism of investment bankers, but only to suggest that the risk of harmful leaks, rumors, and misinformation may have been substantial and potentially fatal in volatile markets. Even so, the companies could have used other investment bankers who were not competitors in capital market activities, such as Lazard, a premier boutique mergers and acquisition advisor with deep expertise in financial institutions.¹²⁶ Another plausible explanation for why the boards of the Bank and Merrill used these advisers is that perhaps the major investment banks did not want to run the risk of advising on this deal under these situational constraints. There may have been substantial liability as well as reputational risks associated with the merger. At the time, most large investment and money center banks were embroiled in their own fights for survival.¹²⁷ The prestige and the fees may not have been worth exposing themselves to the legal risks of issuing a fairness opinion under these constraints, necessitating the appointment of other financial advisers who were more willing to undertake the risks for the fees and the opportunity to work on a landmark deal.

Another point about due diligence is worth mentioning. It is standard protocol that when rendering fairness opinions for a deal, investment bankers do not independently assess the company's assets and liabilities.¹²⁸ Both the FPK and J.C. Flowers fairness opinion letters have such a disclaimer.¹²⁹ The specific disclaimer of non-verification of the

¹²⁵ See *id.* Private equity firms make principal investments in firms or assets, which are held in a portfolio for longer durations. They typically do not engage in trading of securities in a broker-dealer capacity as full service investment banks do.

¹²⁶ Lazard advised Bear Stearns during its crisis and eventual merger with JPMorgan Chase. *Id.* at 73, 88-89.

¹²⁷ See generally ANDREW ROSS SORKIN, *TOO BIG TO FAIL: THE INSIDE STORY OF HOW WALL STREET AND WASHINGTON FOUGHT TO SAVE THE FINANCIAL SYSTEM—AND THEMSELVES* (2009) (describing how Morgan Stanley and Goldman Sachs were in peril during the financial crisis).

¹²⁸ Cf. *Klang v. Smith's Food & Drug Ctr., Inc.*, 702 A.2d 150, 155-56 (Del. 1997) (holding that an investment banker need not calculate assets and liabilities separately in providing a solvency report to the board).

¹²⁹ The FPK fairness opinion letter provides the typical disclaimer on this specific point.

In rendering our opinion, we have assumed and relied, without independent verification, upon the accuracy and completeness of all the information examined by, or otherwise reviewed or discussed with, us for the purposes of this opinion. We have not made or obtained an independent valuation or appraisal of the assets, liabilities (contingent, derivative, off-balance sheet or otherwise) or solvency of the Company or Merrill Lynch, including particularly any mark-to-market balance sheet adjustments resulting from the Merger, market conditions or otherwise. We relied solely upon information provided to us by the Company

company's assets and liabilities is a standard term in fairness opinions.¹³⁰ If the financial advisers were not analyzing the quality of the assets and liabilities, who were? While the fairness opinions spoke to the value of the firm based on market metrics, including transaction and comparable companies multiples and discounted cash flow ("DCF") analysis,¹³¹ such top-down valuations are largely worthless under the extenuating circumstances. The value drivers of the Bank-Merrill merger were not market metrics or theoretical outputs from a DCF model. They were instead the fair values of assets and liabilities, which could only have been determined by a bottom-up, independent assessment of the firm's internal books. The crisis posed unique valuations issues. For instance, in a failing market system the "fair value" may not necessarily have been the "fair market value" per mark-to-market pricing.¹³² There could have been a significant divergence between the "hold" and the "sale" values of exotic and illiquid security with enormous uncertainty as to the former, thus discounting the latter value. Valuation would have required a bottom-up cash flow analysis of the individual assets and liabilities, and calculations of both the "hold" and the "sale" values. When markets are highly unstable or severely malfunctioning, the indices of price reflected in standard market and theoretical valuation techniques cannot possibly form the basis for a fairness opinion, and at least the use of the typical fairness opinion should not provide legal cover for a lack of common sense.¹³³

Only a deal team with proper skills and sufficient time could have performed a bottom-up analysis of the internal books, which is the only way reasonable due diligence could have been done when there is a

and other publicly available information with respect to Merrill Lynch's financial condition, results of operations and prospects.

MERGER PROXY, *supra* note 15, at Appendices D, D-1. Clearly, other aspects of this fairness opinion letter are custom tailored to the unique situation of this merger: for example, the specific reference to "contingent, derivative, off-balance sheet or otherwise." *Id.* J.C. Flowers fairness opinion also provides: "We have assumed and relied upon the accuracy and completeness of the information . . . provided by each of the Company and the Acquiror. We did not independently verify the accuracy or completeness of any such information, nor will we do so in the future, and we did not and do not assume any responsibility for doing so." *Id.* at Appendix C-1.

¹³⁰ See, e.g., Fairness Opinion Letter of Fox-Pitt, Kelton, reproduced in Merger Proxy of Farm Family Holdings, at B-2 (Jan. 19, 2001) ("Fox-Pitt, Kelton has not assumed any responsibility for any independent valuation or appraisal of the assets and liabilities of Farm Family and has not been furnished with any such valuation or appraisal.").

¹³¹ MERGER PROXY, *supra* note 15, at 63-68.

¹³² Mark-to-market is an accounting rule that requires certain assets, such as securities, be stated at their fair value rather than historical cost. See Statements of Financial Accounting Standards No. 157, *Fair Value Measurements*.

¹³³ In analyzing the fairness opinion given in the Bear Stearns deal, William Cohan, a former investment banker, opined: "Given that the choice was between about \$290 million for the 145.5 million Bear shares outstanding and nothing, Lazard's fairness opinion was not a hard one to give . . . rais[ing] the question of why corporate boards agree to pay so much money for a couple of pieces of paper that are of so little value." COHAN, *supra* note 16, at 109.

significant possibility that the target is a distressed financial institution. A few months before, JPMorgan Chase found itself in a similar situation with the rushed, crisis-precipitated acquisition of Bear Stearns. During due diligence occurring over a single weekend, resembling the circumstance of the Merrill acquisition, it appeared that JPMorgan Chase would not proceed with the deal.¹³⁴ A Bear Stearns board member commented on this apparent development: “If I were Jamie Dimon [JPMorgan Chase’s CEO], I would have had some concerns myself because you never do a deal as big as that on one day’s due diligence. What’s the upside versus the downside?”¹³⁵ Notably, JPMorgan Chase continued with the Bear Stearns acquisition only with government financial support and risk sharing arrangements. To suggest that the Bank fully assessed Merrill within a matter of a few hours during extraordinary circumstances is a bridge too far.¹³⁶ The deviation from what is reasonable under the circumstances here is so great that executing the merger agreement while essentially blind to the underlying values of the assets and liabilities of a business as complex as Merrill meets the demanding standard of gross negligence and perhaps even reckless dereliction of duty.¹³⁷ This is a far greater transgression than Jason Van Gorkom’s execution of the merger agreement at the Chicago Lyric Opera, which was largely a problem of optics.¹³⁸

Although the Bank’s board was grossly negligent in executing the acquisition, it would not be liable in fact. The decision in *Smith v. Van Gorkom* resulted in the enactment of DGCL section 102(b)(7).¹³⁹ This statute allows for a provision in the certificate of incorporation eliminating or limiting the personal liability of a director for monetary damages for

¹³⁴ *Id.* at 95.

¹³⁵ *Id.* (quoting Fred Salerno). JPMorgan Chase was able to proceed with the deal despite the problem of proper due diligence only because it received unprecedented financial assistance from the government, including among other things a \$30 billion secured loan. *Id.* at 101.

¹³⁶ Edmund L. Andrews, *Bernanke Defends Role on Merrill*, N.Y. TIMES, June 26, 2009, at B1 (quoting a December 19, 2009 e-mail from Timothy P. Clark, Senior Adviser of the Division of Banking Supervision and Regulation at the Board of Governors of the Federal Reserve System, to senior officials at the Federal Reserve). “I always had my doubts about the quality of the due diligence they did on the [Merrill] deal.” *Id.* (quoting a December 20, 2009 e-mail from Deborah P. Bailey, Deputy Director of the Banking Supervision and Regulation Division at the Board of Governors of the Federal Reserve System. “I think he is worried about stockholder lawsuits; knows they did not do a good job of due diligence and the issues facing the company are finally hitting home and he is worried about his own job after cutting loose lots of very good people.” Lauren Tara LaCapra, *BofA CEO Lewis Not Off the Hook*, THESTREET.COM, June 25, 2009, available at <http://www.thestreet.com/story/10526439/2/bofa-ceo-lewis-not-off-the-hook.html> (quoting a December 23, 2009 e-mail from Mac Alfriend, Senior Vice President in the Supervision, Regulation, and Credit Department of the Federal Reserve Bank of Richmond).

¹³⁷ The failure of corporate governance probably led to the radical board and management changes at the Bank after the Merrill deal closed. *See infra* note 148.

¹³⁸ *Smith v. Van Gorkom*, 488 A.2d 858, 879 (Del. 1985).

¹³⁹ WILLIAM T. ALLEN ET AL., COMMENTARIES AND CASES ON THE LAW OF BUSINESS ORGANIZATION 256-57 (3d ed. 2009).

breach of the duty of care.¹⁴⁰ The Bank, a Delaware corporation, has such an exculpatory provision.¹⁴¹

With the deal execution in context, we can synthesize the operative facts concerning the Bank board's actions in mid-December 2008—*after*, as this Article assumes, the board, the Federal Reserve, and shareholders approved the deal.

The Merrill acquisition had a profound link to the financial markets. The government coerced the Bank's board and management to close the merger. This threat was credible because federal banking agencies have the power to remove a corporation's board and management upon a showing that they engaged in unsafe or unsound practice resulting in financial loss or probable loss.¹⁴² The government was motivated by the need to stem further harm to the financial market, the most immediate problem being a collapse of Merrill on the heels of Bear Stearns and Lehman Brothers.

Lewis's and the board's motivations are more ambiguous. Viewed narrowly in terms of deal economics, closing the acquisition was financially bad for shareholders since the company assumed far greater, multi-billion dollar losses than it had expected.¹⁴³ Like many classic corporate law cases, the motivations of the board and Lewis, acting in his capacity both as CEO and chairman of the board, do not sort into tidy categories or neat characterizations. The episode is colored in shades of gray, and one must engage in some degree of plausible speculation.

The board minutes plainly state that the government's threat did not influence the board members,¹⁴⁴ though such self-serving notice, by itself, cannot be taken seriously. The cynic is sometimes wise. The board was

¹⁴⁰ DEL. CODE ANN. tit. 8, § 102(b)(7) (2008).

¹⁴¹ Amended and Restated Certificate of Incorporation, at ¶ 6 at 25, available at <http://phx.corporate-ir.net/External.File?item=UGFyZW50SUQ9MjExMzB8Q2hpbGRJRD0tMXxUeXBIPtM=&t=1>.

Paragraph 6 provides: "To the fullest extent permitted by the General Corporation Law of the State of Delaware, as the same exists or may hereafter be amended, a director of the Corporation shall not be personally liable to the Corporation, its shareholders or otherwise for monetary damage for breach of his duty as a director."

¹⁴² An appropriate federal banking agency can act "to remove [any institutional-affiliated party] from office or to prohibit any further participation by such party, in any manner, in the conduct of the affairs of any insured depository institution." 12 U.S.C. § 1818(e)(1) (2000). The banking authority must show unsafe conduct, injury or likelihood of injury to the bank, and moral turpitude or scienter. *Id.* The Federal Reserve is a federal banking authority under the statute. *Id.* § 1813(z). An institutional-affiliated party includes "any director, officer, employee." *Id.* § 1813(u). See also William J. Sweet, Jr. & Stacie E. McGinn, *Financial Holding Company Regulation*, 1206 PLI/CORP 465, 499 (Sept. 2000) ("In addition, the Federal Reserve has authority to remove or suspend officers, directors and employees."). Bernanke testified that the Federal Reserve can make or recommend changes in management, but it cannot do so "unconditionally" and must show that poor management damaged the company. Bernanke Testimony, *supra* note 86, at 21-22. As it turned out in 2009 at the time of writing this Article, many board members as well as Lewis subsequently resigned or announced their resignation after the deal closed and the dust from the controversy somewhat settled. See *infra* note 148 and accompanying text.

¹⁴³ See *supra* note 64 & accompanying text.

¹⁴⁴ Board Minutes of Dec. 22, 2008, *supra* note 60, at 3.

aware of the potential for shareholder derivative or federal securities litigation. The board minutes state that Lewis recommended not invoking a MAC because the government told him not to do so, and he changed his mind only in response to Paulson's threat.¹⁴⁵ Internal e-mails at the Federal Reserve show that Lewis was concerned about lawsuits and sought to use the government's position as a legal defense. Scott Alvarez, the general counsel of the Federal Reserve, wrote in an e-mail:

[Lewis] said he now fears lawsuits from shareholders for NOT invoking the MAC, given the deterioration at [Merrill]. I don't think that's very likely and said so. However, he still asked whether he could use as a defense that the govt ordered him to proceed for systemic reasons. I said no. It is true, however, that we have done analyses that indicate that not going through with the merger would pose important risks at [the Bank] itself. So here's my question: Can the supervisors formally advise him that a MAC is not in the best interest of his company? If we did, could he cite that in defense if he did get sued for not pursuing a MAC?¹⁴⁶

In a subsequent e-mail, Alvarez wrote to Bernanke:

All that said, I don't think it's necessary or appropriate for us to give Lewis a letter along the lines he asked. First, we didn't order him to go forward—we simply explained our views on what the market reaction would be and left the decision to him. Second, making hard decisions is what he gets paid for and only he has the full information needed to make the decision—so we shouldn't take him off the hook by appearing to take the decision out of his hands.¹⁴⁷

These e-mails show that the consideration of legal risk was a significant factor in explaining the behavior of Lewis and the board. They also raise the possibility that the purported purpose of providing government aid can possibly be used as a defense to a charge of breach of fiduciary duty.

In light of Lewis's concern about litigation, it is possible that he considered terminating the deal, whether contractually sound or not, because Merrill's losses were exposing the failure of due diligence. This bad outcome called into serious question the competence of the management and the board.¹⁴⁸ Recall that the Bank had the superior bargaining leverage on September 13 when Lewis and Thain negotiated the deal, but nevertheless paid a 70 percent premium for Merrill, which would then go on to lose over \$15 billion in the fourth quarter of 2008.

A flawed due diligence also may be the basis for another explanation. Faced with a badly executed and overpriced deal of his own fault, Lewis may have shrewdly tried to salvage a bad situation by

¹⁴⁵ See *supra* Part I.A.

¹⁴⁶ E-mail of Scott Alvarez (Dec. 22, 2008), available at http://www.usatoday.com/money/_pdfs/09-0611-boa-fed-emails.pdf?loc=interstitialskip.

¹⁴⁷ *Id.*

¹⁴⁸ Bernanke questioned the management's and the board's competence. Bernanke Testimony, *supra* note 86, at 12-13, 23.

threatening to invoke a MAC, legal basis notwithstanding. He coerced a frightened government to make financial commitments, which the Bank in fact got as a part of closing the Merrill deal.¹⁴⁹ In the end, the government also made sure that Lewis and the board paid a personal price for this deception.¹⁵⁰ This explanation suggests that invoking a MAC was not a serious possibility after all, but merely a stalking horse. There are no heroes in this tale, only people making imperfect decisions and exercising bad judgment in extraordinary times and market conditions.

The theory of covering up a badly executed deal finds additional support in internal machinations involving the Bank's senior managers. Timothy Mayopoulos, the Bank's former general counsel, testified to the events leading to his termination.¹⁵¹ The timeline is telling. On November 12, 2008, he was given a written projection showing that Merrill would lose approximately \$5 billion in the fourth quarter.¹⁵² On November 20, the senior management, including Mayopoulos, concluded that the \$5 billion projected loss need not be disclosed to shareholders.¹⁵³ On December 1, senior executives, including the chief financial officer ("CFO"), asked him to review the MAC clause in the merger agreement, and he advised that

¹⁴⁹ See STEVEN M. DAVIDOFF, *GODS AT WAR: SHOTGUN TAKEOVERS, GOVERNMENT BY DEAL, AND THE PRIVATE EQUITY IMPLOSION* 268 (2009) ("This may have been Lewis' strategy all along—knowing the weakness of his [legal] claim he claimed a MAC to win government support."). Bernanke had suspected that Lewis was threatening to invoke the MAC as leverage to extract additional government financial aid, and only later did he believe Lewis was genuinely concerned about the deterioration of Merrill's financial situation. Bernanke Testimony, *supra* note 86, at 23-24. In his memoir, Paulson seems to agree. PAULSON, *supra* note 97, at 429 ("Since we had been so clear about our commitment to a government support program, I doubted that Ken was just testing us."). But he also recalls that "Ken raised the idea of using the clause to renegotiate the terms of the deal with Merrill, and I answered that this would cause the same concerns as invoking the MAC to get out of the deal: it would create an extended period of uncertainty in a market that already was being driven by fear." *Id.*

¹⁵⁰ After the deal closed, the Federal Reserve required the Bank to review its top management, and the company made substantial changes to the board. Bernanke Testimony, *supra* note 86, at 13. Regulators imposed a secret sanction against the Bank that called for board restructuring (and perhaps other undisclosed conditions), and as a result the board composition has undergone a wholesale change. Dan Fitzpatrick, *U.S. Regulators to BofA: Obey or Else*, WALL ST. J., July 16, 2009, at C1 (noting that as of April 29, 2009, seven board members left and were replaced by four new board members). As of July 31, 2009, ten board members left. *Bank of America Exits Include 3 More Directors*, N.Y. TIMES, Aug. 1, 2009, at B2. When asked why Lewis was not replaced, Bernanke answered: "Our judgment at the time was that he could continue to lead the company . . . Obviously, we'll continue to evaluate management and the board as we go forward and make sure that we're comfortable with the leadership at Bank of America." Bernanke Testimony, *supra* note 86, at 49. The practical reality was probably that replacing the board and management in the middle of a crisis may not have been the most prudent thing to do. Moreover, finding capable managers and directors may not be done so quickly. Ultimately, Ken Lewis also decided to resign early for reasons associated with the Merrill Lynch merger and conflicts with government regulators. Carrick Mollenkamp & Dan Fitzpatrick, *With Feds, BofA's Lewis Met His Match*, WALL ST. J., Nov. 9, 2009, at A1.

¹⁵¹ *Bank Of America And Merrill Lynch: How Did A Private Deal Turn Into A Federal Bailout? Part IV, Before the H. Comm. on Oversight and Government Reform*, 111th Congr. (Nov. 17, 2009) (prepared statement of Timothy J. Mayopoulos, Former General Counsel, Bank of Am. Corp.).

¹⁵² *Id.* at 5.

¹⁵³ *Id.* at 6.

there was no MAC because, among other reasons, Merrill's performance was not disproportionately worse than other firms, including the Bank's.¹⁵⁴ On December 3, Mayopoulos learned that Merrill's losses were estimated to be \$7 billion.¹⁵⁵ On December 9, he attended a board meeting and there learned that this estimate had increased to \$9 billion.¹⁵⁶ On December 10, he was fired per Lewis's order.¹⁵⁷ Subsequently, Brian Moynihan assumed the role of general counsel, and he opined that the Bank has a valid case to invoke a MAC.¹⁵⁸ Presumably, with this new advice, Lewis was able to represent to Paulson during their December 17 conversation that he was considering invoking a MAC, whereas he could not credibly do so if his general counsel had advised him there was no MAC.¹⁵⁹

Lewis's use of the MAC as leverage to coerce financial aid is the dark view of the board's motive. However, Lewis is only one board member, albeit the most important, and there are a number of other plausible explanations for the board's decision to close the deal. The board could have been intimidated and unduly influenced by the government. It could have decided to go through with the deal, as the minutes suggest, based on the best interest of the corporation and its shareholders. It could have exercised independent judgment and reasonably deferred to the expert advice of regulators based on broader considerations of systemic risk and public welfare, which were intimately related to the best interest of the company in the longterm though current shareholders suffered in the short term. Lastly, in a complex situation and under stress, perhaps the most likely explanation is that the board acted with mixed motive, taking all of these factors into consideration with each board member assigning different weights to them to come to a collective decision: their entrenchment interest, their desire to remedy a poorly executed deal, the pecuniary interest of shareholders, the long-term interest of the corporation, the financial markets, systemic risk, good faith belief in the expertise of regulators, and the public welfare.¹⁶⁰

¹⁵⁴ *Id.* at 4-5.

¹⁵⁵ *Id.* at 9.

¹⁵⁶ *Id.* at 10-11. Recall that the actual fourth-quarter loss would ultimately be \$15.3 billion. *Id.*

¹⁵⁷ Mayopoulos Prepared Testimony, *supra* note 149, at 11.

¹⁵⁸ Gifford et al. Testimony, *supra* note 63, at 15-16. Apparently, Moynihan had not practiced law in ten years and was not licensed at the time. *Id.* at 16. Effective January 1, 2010, he succeeded Lewis as the Bank's CEO. <http://multivu.prnewswire.com/mnr/bankofamerica/41726/>.

¹⁵⁹ There is some controversy concerning the advice that the Bank's outside counsel, Wachtell, Lipton, Rosen & Katz, gave to the company and regulators. Apparently, Wachtell advised the Bank on December 19, 2008, that it would be difficult, if not impossible, to terminate the deal with Merrill. Zach Lowe, *Wachtell Under Fire*, AMLAW DAILY, Oct. 23, 2009, available at <http://amlawdaily.typepad.com/amlawdaily/2009/10/wachtell-under-fire.html>. However, a few hours later, it told regulators that the Bank could legally terminate the deal. *Id.*

¹⁶⁰ Consider this testimony from one board member: "[F]or me the key decision was not the government threatening board seats because, if that were the key, then I would not be doing my fiduciary duty. The key was the uncertainty of the MAC, to litigate a MAC, to walk away and say we're not going to close.

D. *Merger Closing and Fiduciary Duty*

If the merger execution was flawed, was the decision to close a flawed merger also problematic? In the December 22 board meeting, the Bank's board made three important decisions: (1) not to exercise the MAC; (2) not to renegotiate the purchase price; and (3) not to inform shareholders of accelerating losses at Merrill before closing of the deal.¹⁶¹ Upon an informed decision, the board would be entitled to the protection of the business judgment rule absent disloyalty or bad faith.¹⁶² There would be a loyalty problem if, for example, the board decided not to renegotiate or terminate the deal based on a conflict of interest, such as the desire to avoid scrutiny of its initial flawed decision to approve the merger, or to entrench its interest by acquiescing to the government's demand to close the deal in response to a threat of removal. Let us proceed on the factual assumption that the board's decision was informed, but that the board was conflicted or not independent. The loyalty issue would still have a serious causation problem: that is, whether the board even had the legal option to invoke a MAC at this time.

Found in most merger agreements, a MAC allocates the risk of an adverse event between signing and closing, and is one of the most important clauses in a merger agreement.¹⁶³ The provision in the Bank-Merrill merger agreement defines a "material adverse effect" as "a material adverse effect on (i) the financial condition, results of operations or business of such party and its Subsidiaries taken as a whole . . . or (ii) the ability of such party to timely consummate the transactions contemplated by this Agreement."¹⁶⁴ This definition has a significant carve-out:

The uncertainty of whether we'd win was a lose-lose for the Bank of America shareholders." Gifford et al. Testimony, *supra* note 63, at 24.

¹⁶¹ These decisions, technically inactions or omissions, come within the purview of the business judgment rule because the contrary action (exercising the MAC) was contemplated and rejected in favor of a conscious inaction leading to the scheduled closing of the deal. *See* *Aronson v. Lewis*, 473 A.2d 805, 813 (Del. 1984) ("[A] conscious decision to refrain from acting may nonetheless be a valid exercise of business judgment."); *cf.* *In re Walt Disney Co. Derivative Litig.*, 907 A.2d 693, 748 (Del. Ch. 2005) (stating that "in instances where directors have not exercised business judgment, that is, in the event of director inaction, the protections of the business judgment rule do not apply"), *aff'd*, 906 A.2d 27 (Del. 2006) (en banc).

¹⁶² The presumption of the business judgment rule applies when these two questions are answered affirmatively: Did the board reach its decision in good faith pursuant to a legitimate corporate interest? Did the board do so advisedly? *Gantler v. Stephens*, 965 A.2d 695, 706 (Del. 2009).

¹⁶³ DAVIDOFF, *supra* note 147, at 55-56. *See generally* Robert T. Miller, *The Economics of Deal Risk: Allocating Risk through MAC Clauses in Business Combination Agreements*, 50 WM. & MARY L. REV. 2007 (2009); Ronald J. Gilson & Alan Schwartz, *Understanding MACs: Moral Hazard in Acquisition*, 21 J. L. & ECON. & ORG. 330 (2005); Jonathan M. Grech, Comment, "Opting Out": *Defining the Material Adverse Change Clause in a Volatile Economy*, 52 EMORY L.J. 1483 (2003).

¹⁶⁴ The MAC is found in the merger agreement. MERGER PROXY, *supra* note 15, Appendix A-13 to A-14.

“Material Adverse Effect” shall not be deemed to include effects to the extent resulting from . . . changes in . . . general business, economic or market conditions, including changes generally in prevailing interest rates, currency exchange rates, credit markets and price levels or trading volumes in the United States or foreign securities markets, in each case generally affecting the industries in which such party or its Subsidiaries operate and including changes to any previously correctly applied asset marks resulting there from . . . except . . . to the extent that the effects of such change are disproportionately adverse to the financial condition, results of operations or business of such party and its Subsidiaries, taken as a whole, as compared to other companies in the industry in which such party and its Subsidiaries operate . . .¹⁶⁵

This definition excludes changes in “general business, economic or market conditions, including changes generally in . . . credit markets and price levels or trading volumes in . . . securities market[s],”¹⁶⁶ but imports back into the definition of material adverse effect changes that are “disproportionately adverse . . . as compared to other companies in the industry.”¹⁶⁷

This carve-out most probably would cover the deterioration of asset quality on Merrill’s portfolio. It is clear that the worsening condition of the capital markets directly caused Merrill’s losses. This situation is specifically carved-out of the definition of material adverse effect. The Bank could have argued that Merrill had previously marked its assets incorrectly. However, this is a matter of past due diligence, and the MAC is a forward-looking provision addressing a change in condition after the signing. It would have been difficult to argue that Merrill’s changes were disproportionately adverse as compared to other companies. Merrill was one of only five independent investment banks remaining after the industry consolidation of the 1990s, the others being Goldman Sachs, Morgan Stanley, Lehman Brothers, and Bear Stearns.¹⁶⁸ By the time Merrill was accruing the losses in question, Bear Stearns and Lehman Brother, two true peers of Merrill, had already succumbed to the crisis, and Goldman Sachs and Morgan Stanley were struggling to survive.¹⁶⁹ Most other major financial institutions with investment banking or trading activities, such as Citigroup, AIG, and UBS, were also highly distressed.¹⁷⁰ Importantly, as

¹⁶⁵ *Id.*

¹⁶⁶ This carve-out from a MAC is typical. See DAVIDOFF, *supra* note 149, at 60 (noting that 89 percent of MACs exclude “change in the economy or business in general” and 70 percent exclude “changes in general conditions of the specific industry”) (citations omitted).

¹⁶⁷ MERGER PROXY, *supra* note 15, Appendix A-13.

¹⁶⁸ In the post-Glass-Steagall Act era, most investment banks were acquired by large commercial banks: for example, UBS Warburg and Credit Suisse First Boston. The acquisition of Bear Stearns by JPMorgan Chase, Merrill by the Bank, and Lehman Brothers by Barclays continue this trend. Currently, there are only two pure investment banks, Goldman Sachs and Morgan Stanley, and these firms have converted to bank holding companies in 2008 during the height of the financial crisis. Rhee, *supra* note 11, at 603.

¹⁶⁹ See generally SORKIN, *supra* note 127.

¹⁷⁰ See Eric Dash & Julie Creswell, *Citigroup Saw No Red Flags Even as It Made Bolder Bets*, N.Y. TIMES, Nov. 23, 2008, at A1; Gretchen Morgenson, *Behind Insurer’s Crisis, Blind Eye to a Web of Risk*,

well, the Bank was also distressed, and Merrill's situation was arguably no more adverse than the Bank's.¹⁷¹ By this time as well, the government forced the leading financial institutions, including Merrill and the Bank, to accept TARP funding.¹⁷² Extreme distress in financial condition was the norm in the investment banking and financial institutions sector, which is not surprising given that their distress triggered the worldwide economic crisis.¹⁷³

The MAC was written into the merger agreement on September 14-15, 2008, at a time when the financial markets were becoming highly unstable.¹⁷⁴ The merger consideration was a stock exchange, which meant that the market values of both Merrill and the Bank were subject to fluctuations in the value of their assets. The parties clearly understood that market volatility would likely affect the deal price, but each party equally assumed this risk. Although Merrill suffered heavy losses, they were not a MAC as defined in the merger agreement.

No Delaware case has upheld the exercise of a MAC, and this is the result of a deliberate policy choice.¹⁷⁵ A recent Delaware case, *Hexion Specialty Chemicals, Inc. v. Huntsman Corp.*,¹⁷⁶ which involved a material change experienced during the recent economic crisis, is illustrative. This case demonstrates the challenge the Bank would have faced in a contract dispute with Merrill. There, an acquirer was disappointed with the expected financial performance of the target, which was affected by the economic crisis of 2008.¹⁷⁷ The merger agreement defined a material adverse effect as

N.Y. TIMES, Sept. 27, 2008, at A1; Nelson Schwartz & Julia Werdigier, *UBS to Write Down Another \$19 Billion*, N.Y. TIMES, Apr. 2, 2008, at A1.

¹⁷¹ On a comparative basis, the Bank's stock price underperformed Merrill's for the time period September 15 to December 31, 2008. On September 15, the closing stock prices were: the Bank \$26.55, and Merrill \$13.80. On December 31, the closing stock prices were: the Bank \$14.08, and Merrill \$15.83. There is much information incorporated into the stock, and one such factor here must be the assumption of Merrill's losses by the Bank through the merger, which partially explains the relative stock performance. Nevertheless, the point still holds that the Bank was not in a qualitatively superior position to Merrill during a systemic financial crisis the effects from which no financial institution escaped. See *infra* note 173 and accompanying text.

¹⁷² See *supra* note 36 and accompanying text.

¹⁷³ The Bank's general counsel at the time did not believe that it had a MAC because the Bank was in similarly distressed stated: "[I]n order for there to be a material adverse change, there had to be an event that had occurred that had a disproportionate impact on Merrill Lynch in contrast to other companies in the industry, including Bank of America. And as I discussed with Mr. Price, the stock price of Bank of America had declined almost as much as Merrill Lynch's. Bank of America had gone out and raised substantial capital. It cut its dividend. Its earnings had been reduced. So basically, both companies had suffered significant downturns in their prospects in the time since the merger had been announced." Gifford et al. Testimony, *supra* note 63, at 17.

¹⁷⁴ MERGER PROXY, *supra* note 15, at 50-51.

¹⁷⁵ *Hexion Specialty Chems, Inc. v. Huntsman Corp.*, 965 A.2d 715, 738 (Del. Ch. 2008). See also *In re IBP, Inc. S'holder Litig.*, 789 A.2d 14, 71 (Del. 2001) (contract governed by New York law); *Frontier Oil v. Holly Corp.*, No. Civ. A. 20502, 2005 WL 1039027, at 34 (Del. Ch.).

¹⁷⁶ 965 A.2d 715 (Del. Ch. 2008).

¹⁷⁷ *Id.* at 721.

“any occurrence, condition, change, event or effect that is materially adverse to the financial condition, business, or results of operations,” but there is no materially adverse event if “any occurrence, condition, change, event or effect resulting from or relating to changes in general economic or financial market conditions.”¹⁷⁸ After signing the merger agreement in July 2007, the target suffered in the second half of 2007: a 22 percent shortfall from projections made in June 2007; a 20 percent decline in earnings before interest, tax, depreciation and amortization (“EBITDA”) in the first half of 2008 from the previous year’s results; and as of early August 2008, a projected 32 percent decrease for the forecast year 2008 from 2007 result.¹⁷⁹ These are substantial deterioration of financial performance.

The court of chancery held that no material adverse event occurred.¹⁸⁰ When a target company’s financials deteriorate, the standard is “whether there has been an adverse change in the target’s business that is consequential to the company’s long-term earnings power over a commercially reasonable period, which one would expect to be measured in years rather than months.”¹⁸¹ A MAC protects against the occurrence of unknown events that substantially threaten to produce poor earnings significantly into the future, and not against “short-term hiccup in earnings.”¹⁸² As the court noted, “If Hexion wanted the short-term forecasts of Huntsman warranted by Huntsman, it could have negotiated for that. It could have tried to negotiate a lower base price and something akin to an earn-out, based not on Huntsman’s post-closing performance but on its performance between signing and closing.”¹⁸³

Another Delaware case, *In re IBP, Inc. Shareholder Litigation*,¹⁸⁴ is also a helpful reference. There, material adverse effect was defined as:

any event, occurrence or development of a state of circumstances or facts which has had or reasonably could be expected to have a Material Adverse Effect . . . on the condition (financial or otherwise), business, assets, liabilities or results of operations of [the target] and [its] Subsidiaries taken as a whole.¹⁸⁵

The first quarter of the target’s earnings ran 64 percent behind the comparable prior year’s period.¹⁸⁶ Applying New York law, the court of chancery found the issue “a close one” and concluded that the outcome

¹⁷⁸ *Id.* at 736.

¹⁷⁹ *Id.* at 740.

¹⁸⁰ *Id.*

¹⁸¹ *Id.* at 738.

¹⁸² *Huntsman Corp.*, 965 A.2d at 738.

¹⁸³ *Id.* at 741.

¹⁸⁴ 789 A.2d 14, 68 (Del. Ch. 2001).

¹⁸⁵ *Id.* at 65.

¹⁸⁶ *Id.* at 69.

hinged on the burden and standard of proof.¹⁸⁷ The court ultimately found that the target was a consistently profitable company, but profits were erratic and the company was struggling to implement a strategy to reduce cyclicalities of earnings.¹⁸⁸ Although the target may not have performed as well as the acquirer had hoped, it appeared to be in sound enough shape to deliver results in line with its recent historical performance.¹⁸⁹ According to the court, the acquirer did not meet the burden of proof and thus did not have the right to invoke the MAC.¹⁹⁰

The *Hexion* standard under Delaware law is a heavy burden. Absent a clear contractual intent, Delaware courts would be wary of recognizing a right to terminate a deal based on a material adverse event because such a precedent would cause great mischief in mergers and acquisitions struck during economic downturns and market crises, which would convert buyer's remorse into litigation risk.¹⁹¹ Clearly, both the Bank and Merrill, sophisticated market participants advised by top law firms,¹⁹² had anticipated financial adversity and volatility in the period between the deal's signing and closing. This explains why the MAC carved out an exception for adverse effects resulting from decline in general economic or market conditions, and specifically changes in the capital markets. The magnitude of Merrill's loss may have been disappointing to the Bank, and in this respect, outside of the bounds of hopeful expectation, but the possibility of large losses were certainly contemplated.

If the Bank was concerned about financial deterioration from signing to closing, it could have contractually protected itself with tighter conditions. Attempting to put a collar around the range of loss would have been extremely difficult to negotiate given the volatility of the market.¹⁹³ The stock exchange ratio (0.8595 shares of the Bank's stock for each share of Merrill stock) did not contain a collar or a repricing mechanism. There

¹⁸⁷ *Id.* at 68, 71, 72 n.172. The acquirer seeking to terminate the agreement had the burden of proof by clear and convincing evidence. *Id.* at 54.

¹⁸⁸ *Id.* at 71.

¹⁸⁹ *Id.*

¹⁹⁰ *In re IBP, Inc. S'holders Litig.*, 789 A.2d 14, 71 (Del. Ch. 2001) (contract governed by New York law).

¹⁹¹ "By erecting a hard rule in prior and future cases, Delaware courts ensure that parties who really want to avoid this problem will draft around it. Moreover, this will ensure that the MAC clause is not triggered by systemic risk, risk that cannot be avoided." DAVIDOFF, *supra* note 149, at 75. Economically astute courts realize that contractual uncertainty in financial transactions increase the cost of doing transactions and thereby inject unnecessary cost. *See, e.g.*, *Sharon Steel Corp. v. Chase Manhattan Bank, N.A.*, 691 F.2d 1039 (2d Cir. 1982).

¹⁹² The Bank was represented by Wachtell, Lipton, Rosen & Katz, and Merrill was represented by Shearman & Sterling. Press Release, Bank of Am. Corp., *Bank of America Buys Merrill Lynch, Creating Unique Financial Services Firm*, (Sept. 15, 2008), available at http://www.ml.com/?id=7695_7696_8149_88278_106886_108117.

¹⁹³ A collar in a stock exchange merger typically puts a ceiling and a floor on the implied value of the firms based on stock price, and readjusts the exchange ratio based on a stock price that exceeds the ceiling or floor. *See* Kathleen P. Fuller, *Why Some Firms Use Collar Offers in Mergers*, FINANCIAL REV.

may be several reasons why a collar or repricing mechanism was not used, but one explanation is that the parties understood that a highly volatile market could undermine the deal if it was subject to repricing or was terminable upon exceeding collar limits. The lack of a collar could have been a bond to close the deal, that is, a commitment to forego future options to back out of the deal. Once an exchange ratio is fixed, Merrill's stock price becomes loosely pegged to the Bank's. We can infer that contractual terms typically used to limit the parties' risk would have dramatically increased the likelihood of complication or termination prior to close, which is something *ex ante* neither contracting parties would have wanted. The parties fixed a price upon contract signing, and they took the price risk with respect to the consideration as they saw it at the time. The MAC did not allow for a termination of the merger agreement based on changes in market conditions clearly anticipated by the parties at signing.

Merrill's \$15 billion loss in the fourth quarter was staggering, but it may be merely an indication of extreme market volatility during that same time period.¹⁹⁴ According to an 8-K filing, its losses included: credit valuation adjustments related to monoline financial guarantor exposures of \$3.22 billion, goodwill impairments of \$2.31 billion, and the writedowns on leveraged loans of \$1.92 billion, U.S. Bank Investment Securities Portfolio of \$1.16 billion, and commercial real estate of \$1.13 billion.¹⁹⁵ These losses totaled \$9.74 billion in valuations adjustments to the assets on the existing portfolio, but they stem from Merrill's existing balance sheet and do not indicate a material deterioration of Merrill's forward business prospects. In fact, the losses proved to be short-term (as of the writing of this Article), and Merrill returned to profitability though it has been erratic.¹⁹⁶ Importantly, temporary shortfalls in expectation do not constitute material adverse events. Therefore, the Bank did not have sound basis for invoking the MAC, and the government's advice against such a maneuver was correct.

¹⁹⁴ See *Hexion Specialty Chems., Inc. v. Huntsman Corp.*, 965 A.2d 715, 738 ("A short-term hiccup in earnings should not suffice.") (quoting *In re IBP, Inc. S'holders Litig.*, 789 A.2d 14, 67 (Del. Ch. 2001)).

¹⁹⁵ Bank of Am. Corp., Current Report (Form 8-K), at 13 (Jan. 16, 2009). The "Monoline guarantee" refers to bond insurance, presumably issued by Merrill. Much of the financial crisis was triggered by a precipitous decline in the bond values associated with mortgage-backed securities, which had a cascading effect on the various financial transactions wrapped around these securities, such as derivatives and bond insurance products. See Rhee, *supra* note 11.

¹⁹⁶ In the first quarter ended March 31, 2009, Merrill contributed \$3.66 billion of the Bank's \$12.5 billion in net income. Merrill Lynch & Co., Inc., Quartely Report (Form 10-Q), at 2 (March 31, 2009); Bank of Am. Quarterly Report (Form 10-Q), at 85-86 (May 7, 2009). As of the six months ended June 30, 2009, Merrill contributed \$2.26 billion in net income (the firm lost money in the second quarter). Merrill Lynch & Co., Inc., Quartely Report (Form 10-Q), at 7 (June 30, 2009). By way of comparison, in the previous year's six months ended June 27, 2008, a period before the full brunt of the financial crisis hit in the fall of 2008, Merrill lost \$8.51 billion. *Id.*

Without a material adverse event, the board could not have terminated the merger, or credibly renegotiated the price. In ordinary times, perhaps the Bank could have attempted to invoke the MAC to renegotiate the merger consideration even with a low probability legal hand.¹⁹⁷ Frivolous cases are sometimes settled for positive value, especially when the holder of the legal right is vulnerable.¹⁹⁸ But an attempt to do so in these circumstances would have injected significant systemic risk into the financial system as Paulson testified: “[I]t would be unthinkable for Bank of America to take this destructive action for which there was no reasonable legal basis and which would show a lack of judgment.”¹⁹⁹

Given the absence of a viable legal option, neither the shareholders nor the board could have taken any action to avoid the losses and thus the board had no fiduciary duty under state law to disclose the Merrill losses, however material, outside of whatever SEC obligations there were.²⁰⁰ At the time, market volatility affected the values of assets and liabilities on a day-to-day, mark-to-market basis.²⁰¹ The internal estimations of Merrill’s losses were changing day-to-day in swings of billions of dollars.²⁰² These wild swings in estimates caused the buyer’s remorse. In this situation, the efficacy of disclosure wholly breaks down because one day’s accurate disclosure could very well have been the next day’s inaccurate information. What if the board disclosed a \$12 billion estimated loss on a Monday, and on Friday this estimation increased to \$15 billion? The board must have realized the potentially grave harm the corporation risked sustaining if it voluntarily disclosed certain financial information about Merrill’s mounting losses.²⁰³ Voluntary disclosure of bad news in an unstable market may have resulted in greater harm to both corporations and to a financial market already in peril. These were unprecedented times in the capital markets.

When Paulson threatened to fire the Bank’s management and board, the threat created a potential loyalty problem. It is plausible that the board did not act independently and its members were conflicted. Under Delaware law, a director is independent if she decides on the merits of the

¹⁹⁷ See DAVIDOFF, *supra* note 149, at 62 (“[T]he ambiguous wording of the MAC drives the parties toward settlement of their dispute, albeit at a lower, negotiated price.”).

¹⁹⁸ See Robert Rhee, *Toward Procedural Optionality: Private Ordering of Public Adjudication*, 84 N.Y.U. L. REV. 514, 517 (2009).

¹⁹⁹ Paulson Prepared Testimony, *supra* note 86, at 5.

²⁰⁰ Metro Commc’n Corp. BVI v. Advanced Mobilecomm Techs. Inc., 854 A.2d 121, 153 (Del. Ch. 2004) (internal quotation marks omitted). See also *Malone v. Brincat*, 722 A.2d 5, 12 (Del. 1998) (“The Directors of a Delaware corporation are required to disclose fully and fairly all material information within the board’s control when it seeks shareholder action.”).

²⁰¹ See *supra* text accompanying notes 51, 150, 151, 153, and 154

²⁰² *Id.*

²⁰³ See *Malone*, 722 A.2d at 12; *Stroud v. Grace*, 606 A.2d 75, 85 (Del. 1992).

transaction rather than on extraneous considerations.²⁰⁴ Independence is inconsistent with dominion or control by an individual or entity interested in the transactions.²⁰⁵ A director has a conflict of interest if she will be materially affected by a board's decision, in a manner not shared by the corporation and the shareholders.²⁰⁶ Self-interest includes a desire for entrenchment.²⁰⁷ It is not enough that a contrary decision could result in a loss of position; other facts indicting a disloyal motive must be shown.²⁰⁸ A credible, articulated, direct threat of termination would probably suffice to show a potential loyalty problem.²⁰⁹

The facts established through testimony are: Lewis wanted to exercise the MAC;²¹⁰ Paulson threatened that to do so would result in the termination of the board and management; upon management's recommendation, which was based on "instructions" from the government, the board did not invoke the MAC. These facts plausibly suggest three scenarios: (1) Lewis and the board hoodwinked the government with the threat of invoking a low probability legal strategy with a high probability of large collateral harm if the threat was carried out in an effort to coax public financial aid; (2) upon reconsideration after receipt of the government's strongly termed advice, the board was persuaded by the government's rationale and they exercised independent judgment not to invoke a MAC consistent with the government's reasoning to proceed with closing the merger; or (3) the board lacked independence and simply acquiesced to the government's demand.

Negotiations ethics aside, the first decision advanced the Bank's financial health. The second decision would be an independent, informed business judgment, which may or may not have resulted in net financial harm to the company. These decisions would be entitled to the protection of the business judgment rule. The third decision would be tainted for lack of independence. The board would have rubber stamped a government order. However, the resulting decision would not be automatically void. Section

²⁰⁴ *Seminaris v. Landa*, 662 A.2d 1350, 1354 (Del. 1995); *Aronson v. Lewis*, 473 A.2d 805, 816. See also *Rales v. Blasband*, 634 A.2d 927, 935 (Del. 1993) ("[T]he board must be able to act free of personal financial interest and improper extraneous influences.").

²⁰⁵ *Seminaris*, 662 A.2d at 1354; *Aronson*, 473 A.2d at 816; *Rales*, 634 A.2d at 935.

²⁰⁶ *Seminaris*, 662 A.2d at 1354.

²⁰⁷ *Gantler v. Stephens*, 965 A.2d 695, 706 (Del. 2009); *Grobow v. Perot*, 539 A.2d 180, 188 (Del. 1988), *overruled on other grounds by Brehm v. Eisner*, 746 A.2d 244 (Del. 2000); *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954-55, 958 (Del. 1985).

²⁰⁸ *Gantler*, 965 A.2d at 707.

²⁰⁹ *Id.*

²¹⁰ Lewis represented to the board that he told federal regulators that the Bank would invoke a MAC and seek to renegotiate the transaction with Merrill. Minutes of Special Meeting of Board of Directors of Bank of Am. Corp., at 2 (Dec. 30, 2008), available at http://www.oag.state.ny.us/media_center/2009/apr/pdfs/Exhibit%20to%20a%20to%20a%20_23.09%20letter.pdf [hereinafter "Board Minutes of Dec. 30, 2008"].

144(a)(3) of the DGCL shields a transaction or contract from voidability if it “is fair as to the corporation as of the time it is authorized, approved or ratified, by the board of directors, a committee or the shareholders.”²¹¹ Where there is a loyalty problem, the presumption of the business judgment rule does not apply and the transaction is actively scrutinized for fairness.²¹²

The fairness inquiry would fail for lack of an injury.²¹³ The board’s decision to close the deal was proper for the simple reason that there was no choice. Intentional or not, Lewis and the board incorrectly asserted the legality of invoking the MAC. Terminating or renegotiating the deal would have led to the losing side of a lawsuit. Such action would have damaged the financial market with adverse consequences on both firms.²¹⁴ The board would have run the risk of alienating the government and diminishing the company’s ability to access financial aid, at least with the current board and management still in place. Whether or not the board was unduly influenced, its decision turned out to be fair and advanced the best interest of the company. This could be the unusual case in which the board took the correct action *because it was disloyal*. A plausible motive for attempting to invoke a weak case for a MAC was a desire to remedy a poorly executed and negotiated merger by renegotiating the merger consideration. This ill-advised legal strategy to fix a prior wrong could have produced an even worse outcome for the company. The government, acting in the best interest of the public welfare, forced the correct board action, an outcome possible only when the interests of the public and the corporation are aligned and a risky possibility of increasing the shareholder’s pecuniary stake potentially conflicts with these interests.

What do we conclude from this case study? Legally, liability under Delaware corporate law is unlike because of exculpation for any duty of care violations, and because there simply was no injury to shareholders under an assumption that their vote for the merger was not tainted by faulty disclosure. More broadly, the case study reveals that there is a real possibility, though unlikely given the available facts, that shareholders “took a bullet” in terms of assuming large short-term losses to avoid the injection of more systemic risk into a crippled financial system, and that the company’s management and board, prompted by government entreaties, were motivated in part at least to advance the public’s interest in stabilizing a financial crisis over the shareholder’s immediate pecuniary interest. This

²¹¹ DEL. CODE ANN.tit. 8, § 144(a)(3) (2009).

²¹² See *Weinberger v. UOP, Inc.*, 457 A.2d 701, 710 (Del. 1983) (“[W]here [directors] stand on both sides of a transaction, [they have] the burden of establishing its entire fairness . . .”).

²¹³ See *Dalton v. Am. Inv. Co.*, 490 A.2d 574, 585 (Del. Ch. 1985) (ruling against plaintiff on the ground that the alleged breach of fiduciary duty did not cause the challenged transaction giving rise to the plaintiff’s injury).

²¹⁴ See *supra* note 97 and accompanying text.

recital of the facts, currently known as of the writing of this Article, is important to show the contextual color of the regulatory and corporate decision making. This case study reveals an important aspect of corporate governance that thus far has not had an opportunity to be analyzed: that is, corporate governance is not always a purely private affair, but instead can be a public-private coordinated decision in times of national crisis or systemic risk.

II. FIDUCIARY DUTY ISSUES

A. *Statutory Authority to Promote Public Welfare*

The case study in Part I shows that the Bank had no choice but to assume the heavy financial loss accumulating by Merrill under the terms of the merger agreement. In this second topical section, presented in Parts II through IV, this Article discusses the theoretical issues raised by the role of corporations in public crises. To contextualize the problem, I assume that the Bank could have terminated the deal on the basis of a legally viable material adverse change. Under this counterfactual, the Bank would have been uniquely situated to rescue the financial market by foregoing its legal option to avoid Merrill's losses. This episode shows the real possibility that a board may someday confront the Hobson's choice between maximizing shareholder wealth and protecting the public welfare or wealth. I consider in this second topical section the theoretical dimensions of this counterfactual and provide a framework for analyzing fiduciary obligations.

The counterfactual scenario has a predicate: would the Bank have financially gained if it had exercised a legal right to terminate the merger? This is impossible to answer. We will never know what would have happened, counterfactuals being what they are. Simply put, the answer requires an informed business judgment during great market uncertainty. Lewis, Bernanke, and Paulson agreed that the Bank would not have been immune from the market fallout of Merrill's collapse.²¹⁵ There would have been indirect, immeasurable harm from further market turmoil if the Bank cut Merrill loose, and this cost must be weighed against the more direct, measurable, and enormous financial harm from mooring Merrill's liabilities to the Bank's balance sheet. Even with a sound legal right to terminate the deal and without a government threat overhanging its decision, the Bank may have been better off by not invoking a MAC. An informed board decision made in good faith would have been protected by the business judgment rule even if the outcome is ultimately terrible.

²¹⁵ See Bank of Am. Corp., Current Report (Form 8-K) at 82-83 (Jun. 16, 2009).

Importantly, standard corporate law rules may suffice to deal with extraordinary circumstances. Courts could invoke the elision that a board's decision to assume an enormous financial loss may have some abstract "long-term" benefit,²¹⁶ a Potemkin explanation routinely invoked to shield business judgment from active scrutiny of the merit of ill-advised, stupid or erroneous decisions in furtherance of legitimate jurisprudential reasons.²¹⁷ A board's decision to assume enormous financial loss by voluntarily rescuing another firm may be valid on the ground that the long-term interest of a stable financial market is in the best interest of the corporation and shareholders as well,²¹⁸ similar to the way that the quality of the neighborhood surrounding Wrigley Field was supposedly an important factor in the baseball team's decision not to install lights in *Shlensky v. Wrigley*.²¹⁹ Much of the legitimacy of corporate law, which gives managers great authority over corporate assets, depends on plausible good faith. These elisions are the white lies of corporate law, not malicious or mendacious, but perhaps necessary to maintain a proper decorum of law and policy.²²⁰ As long as a board does not explicitly admit that its motive

²¹⁶ See, e.g., *Shlensky v. Wrigley*, 237 N.E.2d 776, 780 (Ill. App. Ct. 1968) (noting that decisions that may be harmful to current shareholders may be in the "long run" interests of the firm); *Paramount Commc'ns, Inc. v. Time, Inc.*, 571 A.2d 1140, 1151-55 (Del. 1989) (allowing directors discretion to choose "long-run" strategy); *Katz v. Oak Indus.*, 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."). Scholars also distinguish between "short-term" and "long-term" shareholder interest. See Lynn A. Stout, *Bad and Not-So-Bad Arguments for Shareholder Primacy*, 75 S. CAL. L. REV. 1189, 1198 (2002) (distinguishing between "short run" and "long run" interest of shareholders); Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439 (2001) ("There is no longer any serious competitor to the view that corporate law should principally strive to increase long-term shareholder value.").

²¹⁷ Cf. *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959, 967 (Del. Ch. 1996) ("[W]hether a judge or jury considering the matter after the fact, believes a decision substantively wrong, or degrees of wrong extending through 'stupid' to 'egregious' or 'irrational', provides no ground for director liability, so long as the court determines that the process employed was either rational or employed in a good faith effort to advance corporate interests."); *Gagliardi v. TriFoods Int'l, Inc.*, 683 A.2d 1049, 1053 (Del. Ch. 1996) ("[T]hat plaintiff regards the decision as unwise, foolish, or even stupid in the circumstances is not legally significant; indeed that others may look back on it and agree that it was stupid is legally unimportant, in my opinion."). See also STEPHEN M. BAINBRIDGE, *CORPORATION LAW AND ECONOMICS* 414 (2002) (explaining that elision "long-term interest" of the corporation and shareholders is an excuse by courts to abstain from judgments on the substantive merits of the board's decision) and Stephen M. Bainbridge, *The Business Judgment Rule as Abstention Doctrine*, 57 VAND. L. REV. 83 (2004) (arguing that the business judgment rule is a doctrine designed to preclude substantive review of the board's decision).

²¹⁸ See Bank of Am. Corp., Current Report (Form 8-K) at 82-83 (Jun. 16, 2009).

²¹⁹ 237 N.E.2d 776, 780 (Ill.App. 1968) ("[T]he effect on the surrounding neighborhood might well be considered by a director who was considering the patrons who would or would not attend the games if the park were in a poor neighborhood. Furthermore, the long run interest of the corporation in its property value at Wrigley Field might demand all efforts to keep the neighborhood from deteriorating.").

²²⁰ See ALLEN ET AL., *supra* note 138, at 7 ("Efficiency will remain a controversial judicial standard, in part because determining what counts as a 'cost' and what counts as a 'benefit' in a world of incomplete markets, strategic behavior, and informational asymmetry inevitably involves guesswork. In corporate matters, therefore, courts are disinclined to acknowledge the policy rationale for their decisions, even though this rationale is decisive to our normative evaluation of the results courts reach."). It is notable

was purely for the public welfare, as Henry Ford did to his legal detriment in *Dodge v. Ford*,²²¹ courts would most likely accept the proffered explanation, however abstract or undeveloped it may be, and avoid a judicial decision on the merit of the board's decision.²²² During the Merrill acquisition, Lewis repeatedly asserted that the Bank's interest was intertwined with the public interest in a sound, stable financial market.²²³ This assertion anticipates a legal defense, but it is undoubtedly true for a systemically-important bank. Absent particular facts to the contrary and with the incantation of "long-term interest of the corporation and shareholders," the threat of liability is whisked away by the spirit of plausible good faith. Alternatively, the court could actively scrutinize the decision only to find in the end that the empirical merit of the assertion cannot be tested and thus would give dispositive weight to the plausibility of good faith in the proffered explanation.²²⁴ The point is this: the current framework for determining liability would allow a board to provide enormous economic resources during a public crisis. So long as the board's decision is informed and in good faith, and the explanation suggests some nexus to a corporate benefit however abstract or unformulated it may be, the probability of judicial scrutiny is minimized.²²⁵

If so, why is the problem of the Hobson's choice relevant at all? It is relevant for instrumental, jurisprudential, and practical reasons.

that one of the three authors of this passage is former Delaware Chancellor William Allen. Previously, Chancellor Allen argued: "There is a utility in this long-term/short-term device. Though employment of this distinction is subject to obvious manipulation, it can nevertheless resolve the tension between these differing conceptions of the corporation in a way that offers the possibility of some judicial protection to shareholders, while affording substantial room to the multi-constituency, social entity conception to operate." William T. Allen, *Our Schizophrenic Conception of the Corporation*, 14 CARDOZO L. REV. 261, 273 (1992).

²²¹ 170 N.W. 668 (Mich. 1919). Ford testified that "the Ford Motor Company has made too much money, has had too large profits, and that, although large profits might be still earned, a sharing of them with the public, by reducing the price of the output of the company, ought to be undertaken." *Id.* at 683-84.

²²² ALLEN ET AL., *supra* note 138, at 295 ("Thus, *Dodge v. Ford Motor Co.* is unique precisely because Mr. Ford announced that he was acting in the interests of nonshareholder.").

²²³ See Bank of Am. Corp., Current Report (Form 8-K) at 82-83 (Jun. 16, 2009).

²²⁴ See, e.g., *In re Walt Disney Co. Derivative Litig.*, 907 A.2d 693 (Del. Ch. 2005), *aff'd* 906 A.2d 27 (Del. 2006). This litigation concerned the severance payment of \$130 million paid to Michael Ovitz, who was Disney's president for fourteen months. *In re Walt Disney*, 906 A.2d at 35. The plaintiffs argued that this payment constituted a breach of fiduciary duty. 907 A.2d at 697. The trial lasted thirty-seven days, and generated 9,360 pages of transcript and 1,033 exhibits. The chancery court's opinion was 174 pages long. In the end, the Delaware courts held that there was no violation of fiduciary duty. 906 A.2d at 75.

²²⁵ The business judgment rule provides protection for profit-sacrificing discretionary decisions. See Einer Elhauge, *Sacrificing Corporate Profits in the Public Interest*, 80 N.Y.U. L. REV. 733, 738 (2005); D. Gordon Smith, *The Shareholder Primacy Norm*, 23 J. CORP. L. 277, 279-80 (1998) ("The combined effect of the business judgment rule and director exculpation provisions [under DEL. CODE ANN. tit. 8 § 102(b)(7)] is to limit most fiduciary duty claims to breaches of the duty of loyalty, that is, manager self-dealing."); Jill E. Fisch, *Measuring Efficiency in Corporate Law: The Role of Shareholder Primacy*, 31 J. CORP. L. 637, 651-52 (2006) ("[N]o modern court has struck down an operational decision on the ground that it favors stakeholder interest over shareholder interests.").

Instrumentally, a board cannot be assured that the provision of aid to the public would fall under a duty of care and business judgment rule rubric, but instead could be characterized as a duty of loyalty and bad faith issue under which the directors are accused of intentionally harming the corporation if the amount of the aid is considered wasteful. A court may plausibly find that a board acted solely for the benefit of the public welfare (the situation in *Dodge v. Ford*) and possibly impose liability for bad faith.²²⁶ A violation of the duty of loyalty and bad faith conduct are not subject to exculpation under section 102(b)(7), and thus expose directors to the potential for real liability.²²⁷ Jurisprudentially, the recognition of a specific framework for assessing the Hobson's choice would reveal broader policies and assumptions underlying corporate law. A rule of fiduciary safe harbor, for example, would suggest that the economic returns of the factors of production can be subjugated in limited circumstances as an aspirational guidance. Norms serve to elicit beneficial behavior when the law cannot mandate such conduct.²²⁸ Scholars, including former Delaware Chancellor William Allen, have suggested that the schizophrenic scheme of imposing a duty of care and then taking away real possibility of liability provides “the pedagogic function of informing [board members] just what ‘doing the right thing’ means under the circumstances.”²²⁹ Practically, a real possibility of large liability for waste or bad faith would introduce significant legal uncertainty, which may paralyze the decision-making process during a national crisis precisely when such paralysis could cause great harm. A doctrine of fiduciary safe harbor would insulate boards from legal risk, though they may still be checked by the intra-corporation political and reputational considerations. The board's calculation would then revolve around determining just what “the right thing” is under the circumstance.

With these reasons in mind, assume that a board intentionally absorbed a large financial loss, net of all short-term and long-term, direct and indirect factors. Ordinarily, deliberate conduct to injure a corporation, because of either self-interest or bad faith, would obviously violate the duty of loyalty.²³⁰ But the board took this action to avert public harm during a national crisis with the understanding that there is a net loss, perhaps a large

²²⁶ See *infra* note 291 & accompanying text.

²²⁷ See *Malpiede v. Townson*, 780 A.2d 1075, 1094 (Del. 2001).

²²⁸ ALLEN ET AL., *supra* note 138, at 255.

²²⁹ *Id.* at 257. Absent a loyalty problem, a board is protected at various levels through the business judgment rule, section 102(b)(7) exculpation, and directors and officers (“D&O”) insurance. *Id.* at 256-57. Legal liability for a breach of the duty of care is quite rare. *Id.* at 258-59.

²³⁰ See *Stone v. Ritter*, 911 A.2d 362, 369 (Del. 2006) (“[W]here the fiduciary intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties . . .”) (quoting *In re Walt Disney Co. Derivative Litig.*, 906 A.2d 27, 67 (Del. 2006)). See also *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959, 971 (Del. Ch. 1996) (“[O]nly 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.”).

one, to the corporation. The board would have intentionally inflicted financial harm, but would there have been a foul?

Without a conflict of interest, there would be no economic rationale for a privately-subsidized takeover, that is, an acquisition intentionally priced in excess of the intrinsic value of the deal achievable through arms-length bargaining. Such a transaction is per se irrational, and thus made in bad faith. This raises the question of waste. A board is liable for waste when it transfers assets for no corporate purpose or consideration.²³¹ Waste is a difficult standard to satisfy. It is limited to unconscionable cases where directors irrationally squander or donate corporate assets.²³² Ordinarily, courts will not engage in a substantive analysis of the deal: “Courts do not measure, weigh or quantify directors’ judgments. We do not even decide if they are reasonable in this context.”²³³ The outer boundary of the waste inquiry is irrationality.²³⁴

If directors honestly professed a desire to subsidize a transaction for the private benefit of target shareholders, the board would not be entitled to the business judgment rule because the decision would not have been in good faith and in the honest belief that the action taken was in the best interest of the company. The entire transaction would be subject to the fairness standard, and it would fail this standard if the price was in fact subsidized with no legitimate business purpose such that there is an actual injury. Thus, there must be a source of authority allowing a board to specifically provide corporate assets to third-parties. That source is section 122 of the DGCL, which grants corporate boards specific powers to execute transactions that are not in the best financial interest of the corporation or shareholders.²³⁵ Two provisions may apply in a situation where the company makes a substantial financial sacrifice for the benefit of the public welfare.

Section 122(9) provides that a corporation has the power to “make donations for the public welfare or for charitable, scientific or educational purposes, and in time of war or other national emergency in aid thereof.”²³⁶ Because a gift is not attached to consideration, it financially harms the

²³¹ *Brehm v. Eisner*, 746 A.2d 244, 263 (Del. 2000) (quoting *Lewis v. Vogelstein*, 699 A.2d 327, 336 (Del. Ch. 1997)).

²³² *Id.*

²³³ *Id.*

²³⁴ *Id.* at 264.

²³⁵ DEL. CODE ANN. tit. 8 § 122(9) (2009) (allowing a corporation to make “donations for the public welfare or for charitable, scientific or educational purposes, and in time of war or other national emergency in aid thereof”).

²³⁶ *Id.* See also MODEL BUS. CORP. ACT § 3.02(13) (corporation has the power “to make donations for the public welfare or for charitable, scientific, or educational purposes”) and § 3.02(15) (corporation has the power “to make payments or donations, or do any other act, not inconsistent with law, that furthers the business and affairs of the corporation”).

corporation.²³⁷ A donation is a gift,²³⁸ and a gift is the “act of voluntarily transferring property to another without compensation.”²³⁹ An acquirer-subsidized takeover can be considered a donation to the target to the extent of the subsidization.²⁴⁰ True, this is not the ordinary type of corporate gift, but the uniqueness of the circumstance does not make inapposite this provision. There is no restriction that a donation must be made *to* any particular person or types of persons, but instead it must be made *for* some public good.²⁴¹ Thus, section 122(9) embodies the view that corporate gifts can substantially affect the national interest.

The observation of the New Jersey Supreme Court in *A.P. Smith Mfg. Co. v. Barlow*, which has been cited by Delaware courts, is apposite:

During the first world war corporations loaned their personnel and contributed substantial corporate funds in order to insure survival; during the depression of the '30s they made contributions to alleviate the desperate hardships of the millions of unemployed; and during the second world war they again contributed to insure survival. They now recognize that we are faced with other, though nonetheless vicious, threats from abroad which must be withstood without impairing the vigor of our democratic institutions at home and that otherwise victory will be pyrrhic indeed. . . . It seems to us that just as the conditions prevailing when corporations were originally created required that they serve public as well as private interests, modern conditions require that corporations acknowledge and discharge social as well as private responsibilities as members of the communities within which they operate. Within this broad concept there is no difficulty in sustaining, as incidental to their proper objects and in aid of the public welfare, the power of corporations to contribute corporate funds within reasonable limits in support of academic institutions.²⁴²

Note the references to World War I, the Great Depression, World War II, and the Cold War, as well as the way the court linked corporate philanthropy to national crisis and public welfare.

²³⁷ Gifts cannot be justified on the basis that the corporation benefits indirectly. For instance, the New York statute makes explicit that gifts can be made “irrespective of corporate benefit.” N.Y. BUS. CORP. LAW § 202(12) (McKinney 2009).

²³⁸ BLACK’S LAW DICTIONARY 561 (9th ed. 2009).

²³⁹ *Id.* at 757.

²⁴⁰ Cf. I.R.C. § 2512(b) (2000) (“Where property is transferred for less than an adequate and full consideration in money or money’s worth, then the amount by which the value of the property exceeded the value of the consideration shall be deemed a gift, and shall be included in computing the amount of gifts made during the calendar year.”); *Hooker v. Comm’r*, 174 F.2d 863, 865 (5th Cir. 1949) (“‘Where property is transferred for less than an adequate and full consideration in money or money’s worth’ the value in excess of such consideration ‘shall . . . be deemed a gift.’”) (quoting I.R.C. § 1002 (repealed 1954)).

²⁴¹ See *Frankel v. Donovan*, 120 A.2d 311, 316 (Del.Ch. 1956) (“[C]orporate gifts may be made solely for the public welfare or for charitable, scientific or educational purposes . . .”).

²⁴² *A.P. Smith Mfg. Co. v. Barlow*, 98 A.2d 581, 586 (N.J. 1953) (holding that a corporate donation to Princeton University was within a company’s corporate power). See also *Kelly v. Bell*, 254 A.2d 62, 74 (Del. Ch. 1969), *aff’d*, 266 A.2d 878 (Del. 1970) (citing *Barlow* and noting the similarity between corporate gift law in New Jersey law and Delaware).

Benefits to private actors and the public welfare are not mutually exclusive. In the situation of a national emergency, a subsidized takeover benefitting a private target may have a substantial public rationale. This is the precise situation presented in the Bank's acquisition of Merrill. The financial crisis of 2008 was unquestionably a "national emergency" of the highest order, and closing the Merrill acquisition was in the public interest.²⁴³ Without a corporate gift or contribution, taxpayers either through TARP or some other measure may have had to pay for a rescue, or the public may have had to bear the cost of the collapse of Merrill on the heel of Lehman Brothers bankruptcy. At the same time, financial institutions were receiving unprecedented financial aid from the government in an effort to protect private wealth and public welfare. While public funds can be used to prevent such harm, private resources can also be used when a firm is uniquely situated to provide provide a rescue. The assumption of portfolio diversification results in the spreading of the resources across a broad spectrum of shareholders,²⁴⁴ who through their investments have been participants in the market activities and directly benefit from a rescue. Distributing private assets to offset some of the burdens on the greater society is a reason for allowing corporate gifts. As the *Barlow* court reasoned, "our State has not only joined with other states in advancing the national interest but has also specially furthered the interests of its own people who must bear the burdens of taxation resulting from increased state and federal aid upon default in voluntary giving."²⁴⁵ The subsidized acquisition of Merrill would have been a private contribution from the Bank toward the government-led effort to rescue a systemically-important investment bank and to support a collapsing financial market.²⁴⁶

Section 122(9) is not an unrestricted license to the board. Delaware courts recognize a waste limitation subject to a test of reasonableness.²⁴⁷ A subsidized takeover constituting a gift to target shareholders could possibly pass this scrutiny.²⁴⁸ Importantly, the gift's absolute size is not

²⁴³ See *supra* Part I.B.

²⁴⁴ See FRANK H. EASTERBROOK & DANIEL R. FISCHER, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 41 (1991) (assuming diversified shareholders in reasoning the rationality of a lack of shareholder monitoring).

²⁴⁵ *Barlow*, 98 A.2d at 589.

²⁴⁶ I say "would" because the transaction was not subsidized. The Bank did not have a legal option to terminate and thus there was no subsidization after the execution of the merger agreement. See *supra* Part I.A.

²⁴⁷ *Kahn v. Sullivan*, 594 A.2d 48, 51, 61 (Del. 1991); *Kelly*, 257 A.2d at 64.

²⁴⁸ I do not comment on whether the portion of the consideration in excess of fair value should be taxed as a gift. See I.R.C. § 2512(b) (2000). The Internal Revenue Code facilitates corporate gifts by providing a deduction. See *id.* § 170(b)(2)(A) (allowing deductions equal to 10 percent of taxable income). The tax code also provides a helpful guide in determining the reasonableness of a gift. See *Theodora Holding Corp. v. Henderson*, 257 A.2d 398, 405 (Del. Ch. 1969) (finding the limitation on corporate deductions for charitable contributions based on a percentage of total income provides a "helpful guide" for determining what constitutes a reasonably sized gift).

dispositive.²⁴⁹ Other relevant factors are the size of the gift relative of the company's financials,²⁵⁰ and the extent to which the community or public would benefit.²⁵¹ A multi-billion dollar gift would be a stunning sum if viewed in isolation. Yet, we should not be so astonished by a billion dollar donation. In this era of large numbers, a billion seems to be yesterday's million.²⁵² The scale of numbers can be put in perspective by comparing it to the state of executive compensation, which can lead to hundreds of millions or billions of dollars in compensation to executives,²⁵³ and yet Delaware courts have upheld these enormous payouts as legal.²⁵⁴ By suggesting that gifts can reach the range of billions of dollars, I do not mean to be cavalier with enormous sums of money. Rather, the separation of ownership and control, which is an essential feature of the modern corporation,²⁵⁵ allows managers great discretion to control corporate assets without a specific, unqualified legal duty to maximize financial gain or profit.²⁵⁶ It would be dissonant, to say the least, if the structure of corporate law would allow managers to transfer enormous assets to themselves in compensation,²⁵⁷ but not for an exigent social need for the many, including the corporate enterprise itself, which always derives an indirect benefit from a stable economy and society. The size of the gift should bear a relationship to the severity of the crisis.²⁵⁸

²⁴⁹ *Kelly*, 254 A.2d at 74.

²⁵⁰ *Id.* at 61. In *Kahn*, the Delaware Supreme Court upheld a settlement in which the corporation would provide, among other things, \$50 million toward the construction of a museum, where its prior year's pretax earnings were \$574 million. *Kahn*, 594 A.2d at 51, 54.

²⁵¹ *Kelly*, 254 A.2d at 74.

²⁵² *See id.* ("Annually the [gift] payments approximate \$5,000,000, and that is an enormous sum by almost any test.").

²⁵³ For instance, consider the compensation at Goldman Sachs. In fiscal year ended November 2008, Goldman Sachs generated net revenue (revenue net of interest expense) of \$22.2 billion, paid employee compensation of \$10.9 billion, and earned net income of \$2.3 billion. Goldman Sachs Group, Inc., Annual Report (Form 10-K), at 76 (Nov. 28, 2008), available at <http://www2.goldmansachs.com/our-firm/investors/financials/index.html>. This means that employees took 49 percent of net revenue, and shareholders took 10 percent. At the time, it employed 30,067 workers, from janitorial and secretarial staff to bankers and traders to the CEO. *Id.* at 36. The average employee earned approximately \$363,000 in compensation.

²⁵⁴ *See, e.g., supra* note 222 (describing the *Disney* litigation). The problem of executive compensation has been well documented. *See generally* LUCIAN BEBCHUK & JESSE FRIED, *PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION* (2006).

²⁵⁵ ADOLF A. BERLE, JR. & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (Macmillan Co. 1982) (1932).

²⁵⁶ *See* Elhauge, *supra* note 225, at 776-77 (explaining managerial discretion from the perspective of agency cost).

²⁵⁷ *See supra* note 222 (discussing the *Disney* litigation, which concerned a \$130 million severance payment made to Michael Ovitz); *see also infra* note 362 (noting that the former Bear Stearns CEO once held stock valued at approximately \$1 billion).

²⁵⁸ For example, private donations for the victims of the September 11 attacks were \$2.7 billion. Private donations following the 2005 South Asia tsunami overtook government aid. Robert J. Rhee, *Terrorism Risk in a Post-9/11 Economy: The Convergence of Capital Markets, Insurance and Government Action*, 37 ARIZ. ST. L.J. 435, 462 n.129 (2005).

In addition to the gift provision, section 122(12) empowers a corporation to “transact any lawful business which the corporation’s board of directors shall find to be in aid of government authority.”²⁵⁹ Whereas the gift provision focuses on the public welfare, this section focuses on government policy. Surprisingly, while there has been much scholarship on corporate philanthropy,²⁶⁰ no Delaware court has cited or analyzed section 122(12) and scholarly attention has been scant,²⁶¹ presumably because the circumstance required to invoke this power would be most unusual.

The first observation about this provision is its broad grant of authority. Unlike the gift provision, which refers only to power to “make donations,”²⁶² section 122(12) grants authority to “transact *any* lawful business.”²⁶³ The term “lawful business” is the statutory limitation on the scope of authority, and it refers to laws outside of corporate law that may limit, prohibit, or criminalize the contemplated corporate activity. Within this limit, the board has the power to transact “in aid of government authority.” The plain meaning of aid is “help given . . . tangible means of assistance (as money or supplies).”²⁶⁴ The historical definition is a “subsidy or tax granted to the king for an extraordinary purpose” as well as a “benevolence or tribute (i.e., a sum of money) granted by the tenant to his lord in times of difficulty and distress.”²⁶⁵ This etymology is meaningful in the context of the DGCL. Under section 122(12), a board would have the specific and broad power to make a corporation acquisition for the purpose of aiding governmental authority during a global financial meltdown.

An expansive view of board authority is also supported by the statutory history. Up until 1969, section 122(12) read: “In time of war or other national emergency, [corporations are permitted] to do any lawful business in aid thereof, notwithstanding the business or purposes set forth in its certificate of incorporation at the request or direction of any

²⁵⁹ DEL. CODE ANN. tit. 8 § 122(12) (2009); *see also* MODEL BUS. CORP. ACT § 3.02(14) (containing a similar provision: “[T]o transact any lawful business that will aid governmental policy.”). Other states have similar provisions. *See, e.g.*, 15 PA. CONS. STAT. § 5502(a)(12) (2009); R.I. GEN. LAWS § 7-1.2-302(14) (2009); 18 OKLA.STAT.ANN. tit. 18 § 1016 (12) (West 2009); KAN. STAT. ANN. § 17-6102(12) (2009); LA. REV. STAT. ANN. § 12:41(B)(13) (2009).

²⁶⁰ BAINBRIDGE, *supra* note 215, at 436 n.7.

²⁶¹ An initial search shows that only three law review articles have mentioned this provision in passing. David L. Engel, *An Approach to Corporate Social Responsibility*, 32 STAN. L. REV. 1, 14 n.45 (1979); Comment, *Herald Co. v. Seawell: A New Corporate Social Responsibility?*, 121 U. PA. L. REV. 1157, 1162 n.30 (1973); Note, *Liberalizing SEC Rule 14a-8 Through the Use of Advisory Proposals*, 80 YALE L.J. 845, 854 n.43 (1971).

²⁶² DEL. CODE ANN. tit. 8 § 122(9) (2009).

²⁶³ *Id.* § 122(12) (emphasis added).

²⁶⁴ WEBSTER’S NINTH NEW COLLEGIATE DICTIONARY 66 (9th ed. 1985).

²⁶⁵ BLACK’S LAW DICTIONARY 80-81 (9th ed. 2009). *See also* WEBSTER’S, *supra* note 258, at 66 (“[A] subsidy granted to the king by the English parliament until the 18th century for an extraordinary purpose.”).

apparently authorized governmental authority.”²⁶⁶ Several changes are apparent. The board is no longer restricted to a “request or direction” by government, but can instead volunteer aid.²⁶⁷ The new section 122(12) does not restrict aid only to be given in “time of war or other national emergency.”²⁶⁸ It also eliminated “notwithstanding the business or purposes set forth in its certificate of incorporation.”²⁶⁹ This mitigates the apparent conflict between the corporate charter and corporate statutory law, though there would still be a tension if the corporate charter in fact contained a prohibition against such activity.²⁷⁰ The 1969 revision of section 122(12) grants the board “full discretion to authorize any lawful business in aid of government authority.”²⁷¹

The Bank-Merrill episode shows the potential utility of section 122(12). A strong argument can be made that even if the Bank’s board had the option to terminate the transaction, it should not be held liable choosing to assume the \$15 billion loss, as long as the board did so to aid government and rescue the public welfare. Moreover, the statute has application beyond the financial crisis. Crises are a part of the human condition.²⁷² Consider the following hypothetical. There is a full-blown

²⁶⁶ R. FRANKLIN BALOTTI & JESSE A. FINKELSTEIN, 2 BALOTTI & FINKELSTEIN’S DELAWARE LAW OF CORPORATIONS & BUSINESS ORGANIZATIONS § 122 (3d ed. 2009) (discussing 1967 version of DEL. CODE ANN. tit. 8 § 122(12)). Interestingly, the 1967 version of section 122(12) is the current New York formulation: “In time of war or other national emergency, a corporation may do any lawful business in aid thereof, notwithstanding the purpose or purposes set forth in its certificate of incorporation, at the request or direction of any competent governmental authority.” N.Y. BUS. CORP. LAW. § 201(c) (McKinney 2006).

²⁶⁷ See BALOTTI & FINKELSTEIN, *supra* note 266, at § 122.

²⁶⁸ See *id.*

²⁶⁹ See *id.*

²⁷⁰ One commentator has argued that section 122(12) was amended in response to *Medical Committee for Human Rights v. Sec. Exch. Comm’n*, 432 F.2d 659 (D.C. Cir. 1970), *vacated as moot*, 404 U.S. 403 (1972). Note, *supra* note 255, at 854 n.43. There, the SEC excluded a shareholder proposal recommending that Dow Chemical not sell napalm unless it could show that it would not be used against human beings. *Med. Comm. for Human Rights*, 432 F.2d at 663. Management suggested that the company sold napalm not for business reasons (apparently the sales generated little profit and impaired the company’s public image), but because the sale was “morally and politically desirable.” *Id.* at 681. The general cause exclusion of the shareholder proposal rule, Rule 14a-8(c), permits management to omit proposals “submitted primarily for the purpose of promoting a general social, economic, or political cause.” Note, *supra* note 255, at 845. The D.C. Circuit suggested that the Rule was not consistent with the congressional purpose. *Med. Comm. for Human Rights*, 432 F.2d at 680. It suggested that management cannot use the exclusion “as a shield to isolate such managerial decisions from shareholder control.” *Id.* at 681. Thus, the commentator argued that section 122(12) was amended to provide management broader power to aid government and to quell challenges of these kind. Note, *supra* note 255, at 854 n.43.

²⁷¹ BALOTTI & FINKELSTEIN, *supra* note 260, at § 122.

²⁷² See Robert J. Rhee, *Catastrophic Risk and Governance After Hurricane Katrina: A Postscript to Terrorism Risk in a Post-9/11 Economy*, 38 ARIZ. ST. L.J. 581, 582 (“We live in an era of mega-catastrophes.”).

global flu pandemic,²⁷³ and a pharmaceutical company has the only vaccine for this particular mutation of the flu virus. In the past year, the company had \$5 billion in net income. In light of a global pandemic, the board decides to sell the vaccine at cost to wealthy countries and give it away to poorer countries. The cost to the company is \$1 billion in direct cost and \$4 billion in lost profit opportunity. Can the board come to the aid of government and society? While this hypothetical seems melodramatic, we must remember that the economy and the financial market were teetering on the verge of collapse in the fall of 2008, with unthinkable consequences on economies around the world and the welfare of its citizens.²⁷⁴

B. *Fiduciary Exemption, Public Necessity, and the Tort Analogy*

Since no court has spoken on section 122(12) or similar provisions found in other state statutes, we do not know whether the board's authority is bound by a legal limit.²⁷⁵ The plain text of the statute suggests the boundary, much like the gift provision, is very broad at least. Since the government is the primary beneficiary, we may infer that the legislature intended to grant the board great discretion in providing private aid to a public cause. Courts would establish the appropriate standard defining the limit. Even if corporate law is enabled by statute, it is primarily judge-made common law in Delaware.²⁷⁶ Delaware courts could import into section 122(12) a significant limit. For instance, they could construe government aid as a form of philanthropy and impose the same waste standard applicable to section 122(9). Similarly, section 122(15) provides that the corporation has the power to establish compensation plans for its directors, officers, and employees,²⁷⁷ and the board's discretion is not unlimited in this function, at least in theory (the *Disney* litigation has shown that the board's discretion is extremely broad to the point where rationality almost loses meaning).²⁷⁸ A limit on authority is sensible and is suggested by the limits placed on other provisions in section 122.

²⁷³ Society still lives with the specter of the 1918 Spanish flu pandemic, which killed about 50 million people at a time when the global population was 1.8 billion. JOHN M. BARRY, *THE GREAT INFLUENZA: THE EPIC STORY OF THE DEADLIEST PLAGUE IN HISTORY* 396-97 (2004).

²⁷⁴ See *supra* note 36 and accompanying text.

²⁷⁵ There are virtually no cases discussing these statutes. The Rhode Island Supreme Court cited its state statute in issuing an advisory opinion on the constitutionality of another statute. In re Advisory Opinion to the Governor (DEPCO II), 593 A.2d 1356, 1359 (R.I. 1991). But it did not substantively discuss the statute. See *id.*

²⁷⁶ Marcel Kahan & Edward Rock, *Symbiotic Federalism and the Structure of Corporate Law*, 58 VAND. L. REV. 1573, 1591 (2005). Delaware courts have sometimes ignored the statute or have even judicially rewritten it. *Id.* at 1594-95.

²⁷⁷ DEL. CODE ANN. tit. 8 § 122(15) (2009).

²⁷⁸ See *supra* note 222 and accompanying text.

However, there are countervailing considerations. A legal limit on section 122(12) would be problematic. First of all, the waste standard applicable to gifts is inadequate, unless the standard as applied to a crisis is malleable. Otherwise, it would be too restrictive under the circumstances because the provision of assets on par with a corporate gift to a hospital or museum, for example, may be insufficient. Recall that the Bank assumed Merrill's \$15 billion fourth-quarter loss; this loss may be so breathtaking that it constitutes clear waste from the standpoint of an ordinary corporate gift. One expects that any meaningful aid during a public crisis may be substantial, thus automatically creating a potential legal liability for the board if the provision of resources are commensurate with the enormity of the stake involved. There is a potential Catch-22 absurdity: the exigency of the situation creates a real legal risk when a board exercises the very authority granted by statute.

The existence of legal risk raises the question of whether a board's authority should be qualified or absolute. Let us first consider a limiting principle. If there is to be one, such principle should be the foundation of the business judgment rule, specifically an appropriate ex ante procedure leading to an informed, good faith decision with the limit of rationality as the outer boundary. During a national crisis, the limit of rationality would be the point at which the board's decision could be said ex ante to have financially endangered or impaired the corporation as a going concern. Corporate endangerment, self-mutilation or suicide is not an aspirational end of corporate law.²⁷⁹ The risk of such event occurring is sufficiently great from the acts of the unfortunate, negligent or corrupt manager, and the law need not add to this burden. Therefore, a reasonable limiting principle may be that the board would be irrational when it takes action knowing ex ante that its action would impair the corporation's long-term financial health as a going concern.

Although there is a strong argument for a limiting principle, this Article proposes that there should be a fiduciary exemption when a board determines that the firm is uniquely situated to respond to a public crisis, and it acts under section 122(12) in "aid of government authority" or otherwise provides aid to the public. A fiduciary safe harbor is better because it removes legal risk from the board's decision involving a public necessity. The experiences in tort law and public catastrophes have shown that the paralyzing effect of litigation risk is real during a public crisis and can lead to very poor outcomes.²⁸⁰ A small probability of liability would

²⁷⁹ Cf. Wells M. Engledow, *Handicapping the Corporate Law Race*, 28 J. CORP. L. 143, 149 (2002).

²⁸⁰ The Pennsylvania Supreme Court's reflection on history is informative:

We find, indeed, a memorable instance of folly recorded in the 3 Vol. of Clarendon's History, where it is mentioned that the Lord Mayor of London, in 1666, when that city was on fire,

not be reassuring. Public crises may require consequential decisions with large sums of resources at stake. A low probability, high magnitude liability payout may still result in a significant expected value of the legal risk. Exposure to such litigation risk may be sufficiently high to deter potentially beneficial motive and action. The Bank-Merrill episode provides a useful data point. As Lewis was resigning himself to the fact that the Bank had to close the Merrill merger, he was concerned about litigation risk, so much so that he sought a “comfort letter” from the government to use as a part of a legal defense strategy.²⁸¹ A thought that must have obviously crossed the minds of the board and legal advisers was the impact on the liability to the board of the government’s coercion and a perceived decision to close the Merrill deal based on public welfare considerations.

Authority without legal limit, which is another way to view a fiduciary safe harbor, would be novel. In justifying this rule, I reiterate the basic assumption that the cost-benefit of providing aid during a public crisis would be clear. A fiduciary exemption could be seen as removing all controls on management discretion. That is not the case. No *legal* limit on authority is not equivalent to no limitation in fact. First of all, the necessity of a public crisis limits the circumstances in which a board can act under section 122(12) and claim fiduciary exemption. The nature of crises, being what they are, is fairly indisputable. A private rescue would most likely be coordinated with or at the request of the government,²⁸² though the power to provide aid under section 122(12) resides with the board. The notion that a board would gin up the excuse of a public crisis as subterfuge for an illicit asset transfer to the public, a third-party or the government is unrealistic.

One fear may be that, absent a limit on authority, a board could impair the corporation as a going concern to promote the public welfare. This fear is more abstract than real. Self-preservation is a powerful instinct even when a board is acting as an agent for the legal entity.²⁸³ The moral sentiment of a good Samaritan is limited by the perceived economic and moral obligations to the various constituents of the corporation, including shareholders, creditors, employees, and communities, all of whom benefit from the firm as a going concern. Board members are also bound by their own reputational interests, and a good deed at a ruinous cost to the

would not give directions for, or content to, the pulling down forty wooden houses . . . for fear he should be answerable for a trespass; and in consequence of this conduct half that great city was burnt.

Respublica v. Sparhawk, 1 Dall. 357, 362 (Pa. 1788)..

²⁸¹ See *supra* notes 142-45 and accompanying text.

²⁸² For example, the bailout of Long-Term Capital Management was a private rescue coordinated by the government. See generally ROGER LOWENSTEIN, WHEN GENIUS FAILED: THE RISE AND FALL OF LONG-TERM CAPITAL MANAGEMENT (2000) (recounting the history).

²⁸³ See Engledow, *supra* note 279, at 149.

corporation would not assure a board member's standing among her peers or in the corporate ballot box. Again, the Bank-Merrill episode provides a useful reference. Upon learning of the losses accumulating at Merrill, Lewis's professed instinct was to abort the deal to save the company or his reputation. If we are to take at face value his view of events, he only changed his mind upon being persuaded by a government with a heavy hand of the consequences of a Merrill collapse. The instinct for market self-preservation and personal self-interest are powerful constraints on a desire to provide overly generous provision of aid to the impairment of the corporate enterprise.

Another fear may be that a board could promote whatever social agenda it may harbor under the guise of providing aid during a crisis. This is a classic agency cost argument. This fear is also more abstract than real. First of all, there is already authority to do this; a board can lawfully provide gifts to promote the public welfare, and this authority is quite broad. More to the point, just because there is a public crisis, one does not expect that corporate boards would be indiscriminately using the crisis as an excuse to provide large resources toward pet projects, unrelated to the crisis and in amounts that would trigger the threat of litigation. The hypothetical is far-fetched. For instance, the financial crisis concerned financial institutions and, crisis or not, we do not expect firms unrelated to the crisis to provide consequential aid. The situational context dictates that for a firm to consider a rescue at all, it would have to be uniquely situated in relation to the crisis. We would not expect Pfizer to rescue financial institutions during a crisis in the financial markets, and likewise we would not expect JPMorgan Chase to rescue the public during a global flu pandemic. A direct causality would connect corporate munificence. The uniqueness of a firm's situation in relation to the public crisis provides a natural, extra-legal constraint on board action.

There is also a pragmatic political reason for fiduciary exemption. The primary threat to state corporate law is federal intervention.²⁸⁴ What if state corporate law undermined federal policy by deterring corporate cooperation with government policy or punishing corporate boards with liability when the dust settles? To the extent that state law would impose a limitation on a corporation's ability to aid federal policy during a national crisis, the federal government may intervene and enact corporate law consistent with the federal government's regulatory goals (Part IV, *infra*, discusses this issue in greater depth).

²⁸⁴ Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV. 588, 604 (2003). See Griffith, *supra* note 118, at 54 & n.222 ("And if the federal government passes legislation or regulations moving corporate law, in whole or in part, into the federal sphere, the authority of the Delaware judiciary over those matters is effectively preempted.") (citing *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 478-79 (1977)).

Based on the above reasons, a rule of fiduciary exemption is more sensible. The rule is simply stated: upon a public necessity, a board of a firm that is uniquely situated to avert or mitigate a public crisis is exempt from its ordinary fiduciary duty to the corporation insofar as it distributes corporate assets with the intent to aid the government or the public.

The theoretical justification for fiduciary exemption can be found in a well established doctrine of tort law dealing with public crisis and necessity. As a prefatory matter, I note that corporate law borrows much of its concepts of duty and standard of liability from tort law.²⁸⁵ The analogy to tort law is a natural one. Tort law concerns legal wrongs as primarily determined through case-by-case adjudication, and this common law process defines the parameters of the standards of conduct constituting one's obligation not to harm others. The most obvious application of tort law principles is a director's duty of care, which defined in terms of a cause of action for negligence.²⁸⁶ Of course, the analogy is imperfect. The exceptional aspect of corporate law is that for policy reasons directors are protected through various devices such as the business judgment rule and exculpation under section 102(b)(7) for monetary damages.²⁸⁷ But these devices are corporate law's overlay on top of the fundamental principles of duty and fault.

The tort analogy does not stop at the concept of negligence. The duty of loyalty resembles concepts in tort law. Classic conflict of interest transactions and expropriation of assets find their doctrinal roots, in part at least, in the civil wrongs of conversion and fraud. Tort law recognizes special causes of action such as insurance bad faith,²⁸⁸ and more generally it provides a framework for assessing liability based on a level of scienter falling below some hostile purpose or motive. For instance, it defines

²⁸⁵ See Allen et al., *Function Over Form*, *supra* note 118, at 1301 ("Thus, claimed breaches of the duty of care were essentially subjected to traditional tort analysis, i.e., whether the duty was violated, and if so, whether the violation caused harm to the corporation or the shareholders, and the burden of proof fell upon the plaintiff."); Melvin A. Eisenberg, *The Duty of Care of Corporate Directors and Officers*, 51 U. PITT. L. REV. 945, 945 (1990) ("The duty of care of corporate directors and officers is a special case of the duty of care imposed throughout the law under the general heading of negligence."); EASTERBROOK & FISCHER, *supra* note 244, at 93 (analogizing the fiduciary principle to tort law).

²⁸⁶ ALLEN ET AL., *supra* note 138, at 240.

²⁸⁷ See ALLEN ET AL., *supra* note 138, at 253-55 (noting differences between the standards of liability under the corporate and tort doctrines due to the business judgment rule); BAINBRIDGE, *supra* note 215, at 286-87; Henry G. Manne, *Our Two Corporation Systems: Law and Economics*, 53 VA. L. REV. 259, 270 (1967); EASTERBROOK & FISCHER, *supra* note 244, at 93. See also ALLEN ET AL., *supra* note 138, at 256-60 (discussing the business judgment rule and section 102(b)(7) exculpation). Liability insurance is available to tortfeasors, and directors and officers can be protected by D&O insurance.

²⁸⁸ See, e.g., *Pavia v. State Farm Mut. Auto. Ins. Co.*, 626 N.E.2d 24, 27-28 (N.Y. 1993) (holding that the tort of insurance bad faith arises when the insurer has a "gross disregard" for the insured's interest); *Walter v. Simmons*, 818 P.2d 214, 221 (Ariz. Ct. App. 1991) (holding that an insurer is liable for bad faith "when the insurer's conduct is 'consciously unreasonable'"). Other areas of the law have incorporated the concept of good faith. See generally Claire Moore Dickerson, *From Behind the Looking Glass: Good Faith, Fiduciary Duty & Permitted Harm*, 22 FLA. ST. U. L. REV. 955 (1995).

“intent” in intentional torts to include substantial certainty of the outcome though the actor may not have desired the outcome.²⁸⁹ Below this level of scienter is recklessness, which is defined as when an actor knows or has reason to know of facts that would lead a reasonable person to realize that his act or intentional omission not only creates an unreasonable risk of harm, but also that such risk is substantially greater than that which is needed to meet the negligence standard.²⁹⁰ These gradients of culpability are analogous to those applied in corporate law. For instance, under Delaware law, bad faith conduct by the board resulting in harm to the corporation is a subset of a violation of the duty of loyalty.²⁹¹ A director can be found liable for failure to monitor if “he has recklessly reposed confidence in an obviously untrustworthy employee, has refused or neglected cavalierly to perform his duty as a director, or has ignored either willfully or through inattention obvious danger signs of employee wrongdoing.”²⁹² Consider the *Caremark* formulation of liability based on “sustained or systematic failure of the board to exercise oversight,”²⁹³ which implies deliberate disregard of substantial risk of a bad outcome. The formulation for bad faith in *Disney* is “intentional dereliction of duty, a conscious disregard for one’s responsibilities,”²⁹⁴ which is a particularized standard of reckless behavior. These statements of culpability are derivative of tort standards, though they are embellished with a corporate law twist, meaning that residual ambiguity in the standard leaves much interpretive discretion to courts.²⁹⁵

The influence of tort law is seen even in the realm of takeover law. It is apparent that the law of self-defense informs Delaware’s standard for

²⁸⁹ RESTATEMENT (SECOND) OF TORTS § 8A (1965) (defining substantial certainty of outcome as intent). See also *id.* § 13 cmt. c (“It is immaterial that the actor is not inspired by any personal hostility to the other, or a desire to insure him.”).

²⁹⁰ *Id.* § 500 (1965). See also W. PAGE KEETON, PROSSER AND KEETON ON THE LAW OF TORTS 212-13 (5th ed. 1984) (defining “reckless” as the unreasonable disregard of a known or obvious risk so great as to make it highly probable that harm would follow).

²⁹¹ *Stone v. Ritter*, 911 A.2d 362, 370 (Del. 2006). See also Claire A. Hill & Brett H. McDonnell, *Stone v. Ritter and the Expanding Duty of Loyalty*, 76 FORDHAM L. REV. 1769, 1778 (2007).

²⁹² *Graham v. Allis-Chalmers Mfg. Co.*, 188 A.2d 125, 130 (Del. 1963).

²⁹³ *In re Caremark Int’l Inc. Derivative Litig.*, 698 A.2d 959, 971 (Del. Ch. 1996).

²⁹⁴ *In re Walt Disney Co. Derivative Litig.*, 906 A.2d 27, 66 (Del. 2006).

²⁹⁵ The line separating “gross negligence” and “reckless” and “abdication” and “intentional dereliction” and “systematic failure” may not be clearly visible to even Delaware jurists.

It is clear from reading *Graham v. Allis-Chalmers Mfg. Co.*, 188 A.2d 125 (Del. 1963)] and *Aronson v. Lewis*, 473 A.2d 805 (Del. 1984)] together that “concepts of gross negligence” would include behavior which is “reckless” or “cavalier”—words used by the *Graham* Court. Although gross negligence can theoretically exist where proof shows behavior that is less culpable than “reckless” or “abdication,” the use of those adjectives, while inconsistent with ordinary negligence, may not have been intended to carve out a Delaware standard less exacting than gross negligence in the oversight context.

E. Norman Veasey & Julie M.S. Seitz, *The Business Judgment Rule in the Revised Model Act, the Trans Union Case, and the ALI Project—A Strange Porridge*, 63 TEX. L. REV. 1483, 1503 (1985).

reviewing the appropriateness of a board's adoption of antitakeover defenses. Under *Unocal Corp. v. Mesa Petroleum*,²⁹⁶ the target has the burden to establish that the board reasonably perceived that the hostile takeover bid was a threat to the corporation, and the takeover defensive measure adopted was reasonable in response to the threat.²⁹⁷ This standard is analogous to the tort standard, which provides that self-defense measures cannot be "in excess of that which the actor correctly or reasonably believes to be necessary for his protection."²⁹⁸ In both circumstances of self-defense, there must be a reasonable perception of a threat met with a response that must be commensurate with the threat level.

It is fair to suggest that tort law informs the liability scheme of corporate law as the two bodies of law fundamentally concern wrongful conduct and liability therefrom, though obviously applications and policies may differ, perhaps substantially so, in the details. If tort law is a reference point, if not as the pole star, for the liability framework of corporate law, it may prove useful in analyzing a board's liability for financial harm arising from a private sacrifice of corporate profit or assets. Specifically, the tort doctrine of public necessity provides a theoretical justification for fiduciary exemption.

In tort law, the defense of necessity is treated differently depending on whether the necessity is a private or public need. Private necessity is a defense to an intentional tort against property,²⁹⁹ but this privilege is incomplete. Under the rule set forth in *Vincent v. Lake Erie Transportation Co.*,³⁰⁰ the defendant must still provide compensation for any harm done.³⁰¹ A sailor has a privilege to moor his boat on another person's dock during a sudden storm,³⁰² but must pay for damage done. On the other hand, public necessity creates a complete defense. The Restatement provides this formulation: "One is privileged to commit an act which would otherwise be a trespass to a chattel or a conversion if the act is or is reasonably believed to be necessary for the purpose of avoiding a public disaster."³⁰³ A public necessity is a situation when there is a broader threat to the public wealth or

²⁹⁶ 493 A.2d 946 (Del. 1985)

²⁹⁷ *Id.* at 954-55.

²⁹⁸ RESTATEMENT (SECOND) OF TORTS § 70(1) (1965).

²⁹⁹ See *Soldano v. O'Daniels*, 190 Cal. Rptr. 310, 317 (Cal. Ct. App. 1983) (privilege to use tavern phone to aid the victim of a crime); *Ploof v. Putnam*, 71 A. 188, 189 (Vt. 1908) (privilege to use another person's dock to moor one's boat during a sudden storm).

³⁰⁰ 124 N.W. 221 (Minn. 1910).

³⁰¹ *Id.* at 222.

³⁰² *Ploof*, 71 A. at 189.

³⁰³ RESTATEMENT (SECOND) OF TORTS § 262 (1965). Under this formulation, a person is immune from liability even if he was wrong about the existence of a public necessity as long as the belief was reasonable. *But see* *Struve v. Droge*, 62 How. Pr. 233 (N.Y. Sup. Ct. 1881) (holding that in cases of public necessity "they were, by the common law, bound, at their peril, to decide correctly as to such necessity, to protect themselves from liability to make good the loss").

welfare. The common law has long recognized this defense, which dates back as far as 1609 to *Mouse's Case*,³⁰⁴ and it states that an actor who harms the property of another in response to a public emergency is not liable to the property owner.³⁰⁵ Although this defense is generally invoked by a public official,³⁰⁶ private actors can invoke it so long as the emergency is reasonably believed to endanger the general public.³⁰⁷

Both private and public necessity defenses are based on efficiency considerations. The rule of private necessity under *Vincent* is justified on the basis that a private actor will not take property of another that costs more to preserve her property.³⁰⁸ The efficiency consideration of public necessity is more apparent: the cost-benefit analysis always weighs in favor of preserving the public welfare or wealth over private property.³⁰⁹ This rule clearly satisfies the Kaldor-Hicks criterion.³¹⁰ Nevertheless, the question is: why not impose the imperfect privilege of *Vincent* and thus require the delivery of actual compensation?³¹¹ The simple answer is that the cost-benefit always works in favor of mitigating a public crisis and the risk is too great from the moment's hesitation by an actor who is in a position to rescue based on the calculation of the risk of liability.³¹²

Of course, the tort analogy is imperfect. Parties in torts are typically related only by the accident. A corporate board is a fiduciary to the corporation, and so there is a well-defined ex ante relationship. A fair question is whether this prior, legally defined relationship is inalienable thereby precluding an exemption. A fiduciary relationship should not be considered immutable. Fiduciary duty is not an end, but a means to a broader policy. What is that policy? According to former chancellor and now professor William Allen, it is "the creation of economic wealth through the facilitation of voluntary, ongoing collective action."³¹³ I do not argue that Allen's formulation is *the* end of corporate law, but certainly it

³⁰⁴ (1609) 77 Eng. Rep. 1341 (K.B.) (holding that "it is lawful for any passenger to cast the things out of the barge [upon a sudden storm] . . . everyone ought to bear his loss for the safeguard and life of a man").

³⁰⁵ RICHARD A. EPSTEIN, *CASES AND MATERIALS ON TORTS*, 70 (9th ed. 2008).

³⁰⁶ *See, e.g., Surocco v. Geary*, 3 Cal. 69, 72, 74 (1853) (holding that the mayor of San Francisco was not liable for ordering the destruction of the plaintiff's home).

³⁰⁷ KEETON, *supra* note 285, at 146-47. *See, e.g., Mouse's Case*, (1609) 77 Eng. Rep. 1341 (K.B.).

³⁰⁸ The efficiency consideration is seen if one imagines that the actor owns both properties. *See* Richard A. Epstein, *A Theory of Strict Liability*, 2 J. LEGAL STUD. 151, 158 (1973) ("The Transportation Company, now the sole-party involved, would, when faced with the storm, apply some form of cost-benefit analysis in order to decide whether to sacrifice its ship or its dock to the elements."). *See also* Bamford v. Turnley, (1862) 122 Eng. Rep. 25, 33 (Exch. Div.) (providing a single owner hypothetical analysis in determining whether compensation should be provided in nuisance).

³⁰⁹ *Respublica v. Sparhawk*, 1 Dall. 357, 362 (Pa. 1788).

³¹⁰ *See* RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* 13 (7th ed. 2007).

³¹¹ Actual delivery of compensation is not required to satisfy the Kaldor-Hicks criterion. *See id.*

³¹² *Respublica*, 1 Dall. at 362.

³¹³ ALLEN ET AL., *supra* note 138, at 2 ("[T]he modern law of organizational forms—most notably corporation law—is premised on the idea that facilitating individuals' efforts to create wealth is wise public policy.").

captures an important consideration. Although fiduciary duty promotes the policy of wealth creation by mandating the board's fidelity to the corporation, fiduciary exemption is consistent with the policy of wealth or welfare maximization through collective action in the limited circumstance of a public crisis. In the case of a public crisis, the real issue is whether or not priority is given to wealth distribution to shareholders or the preservation of aggregate societal wealth or welfare. The board's relationship to the corporation is not solely defined by an instruction to accumulate wealth for shareholders, which by creating residual income tends to increase societal wealth and welfare. Aspects of corporate law refute this narrow view. As we have seen, sections 122(9) and 122(12) grant authority for the distribution of assets to others without consideration, and a number of states have enacted constituency statutes that authorize the board to consider various constituencies.³¹⁴

With respect to the question of duty, tort law again provides a useful analogy. In tort doctrine, duty does not exist in a state of nature. Whether a duty exists is laden with policy considerations, the most famous example of which is *Palsgraf v. Long Island Railroad*.³¹⁵ The existence of duty is a legal question, and courts "fix the duty point by balancing factors, including the reasonable expectations of parties and society generally . . . and public policies affecting the expansion or limitation of new channels of liability."³¹⁶ This jurisprudential method is not limited to the realm of torts. Delaware courts have applied a similar policy-based analysis to shift fiduciary duty to creditors in insolvency (as discussed further in Part III).³¹⁷ The recognition of a limited exemption is the next iteration in the development of a fiduciary framework based on a broad goal of social wealth or public welfare maximization arising from voluntary, collective action. A fiduciary safe harbor may be justified if the underlying policy is sufficiently compelling and consistent with the broader goals of corporate law. Public necessity and the cost-benefit of a rescue, this Article argues, meet this criterion to justify a fiduciary safe harbor for a corporate board and thus eliminate legal risk from the board's consideration when the threat to the public is grave.

³¹⁴ See Guhan Subramanian, *The Influence of Antitakeover Statutes on Incorporation Choice: Evidence on the "Race" Debate and Antitakeover Overreaching*, 150 U. PA. L. REV. 1795, 1827 (2002) (identifying 31 states that have adopted corporate constituency statutes).

³¹⁵ 162 N.E. 99 (N.Y. 1928). See also William L. Prosser, *Palsgraf Revisited*, 52 MICH. L. REV. 1, 15 (1953) ("These are shifting sands, and no fit foundation. There is a duty if the court says there is a duty . . .").

³¹⁶ 532 Madison Ave. Gourmet Foods, Inc. v. Finlandia Ctr., Inc., 750 N.E.2d 1097, 1101 (N.Y. 2001) (citation and internal quotation marks omitted). This case concerns the question of whether a tort duty exists in the context of a pure economic loss.

³¹⁷ See *infra* text accompanying notes 359–366.

III. SHAREHOLDER PRIMACY IN CRISIS

While the legal issues concerning the Bank board's actions can probably be resolved in litigation without breaking new ground, the episode and the permutations of counterfactuals expose a recurring, fundamental tension in corporate law. What is the purpose of the corporation and more generally business? The answer to this question depends on one's conception of the firm and view of shareholder primacy.

There are two broadly defined, competing views of the firm. The "property model" views the corporation as a collective set of contractual rights to the production of the firm.³¹⁸ This conception is rooted in an economic theory of the firm. Many economists and corporate law scholars, drawing on the foundational work of Ronald Coase,³¹⁹ have argued that corporate law can be seen "as a standard-form contract, supplying terms most venturers would have chosen but yielding to explicit terms in all but a few instances."³²⁰ Corporate law is seen fundamentally as a contractual governance structure, providing a standard set of contractual terms from which the parties can modify and add.³²¹ On the other hand, the "entity model" views the corporation as an entity having significance independent from the property interests of its claimants.³²² An independence from the property claims of capital providers allows the manager to consider more broadly the interests of other constituents who do not have a formal contractual nexus to the firm.³²³ Of course, there are nuances to these models, big and small, but an exploration of the theory of the firm is not the purpose of this Article. For the purpose here these basic characterizations suffice.

The two competing conceptions of the firm are at the heart of the debate on the purpose of the corporation.³²⁴ The property model situates the firm and corporate law squarely within the realm of private law.³²⁵ The entity model allows the public interest to regulate the behavior of manager and corporate activities through corporate law.³²⁶ The property model has strong support from academics, activist investors, and increasingly directors, while the entity theory of the firm has support from corporate

³¹⁸ See William T. Allen, *Contracts and Communities in Corporation Law*, 50 WASH. & LEE L. REV. 1395, 1398-99 (1993) (describing the property and entity models of the firm).

³¹⁹ R.H. Coase, *The Nature of the Firm*, 4 ECONOMICA 386 (1937).

³²⁰ EASTERBROOK & FISCHER, *supra* note 244, at 15.

³²¹ Allen, *supra* note 312, at 1400.

³²² *Id.* at 1402. See also Margaret Blair & Lynn Stout, *A Team Production Theory of the Firm*, 85 VA. L. REV. 247 (1999).

³²³ Allen, *supra* note 312, at 1402.

³²⁴ Allen, *supra* note 220, at 264-66.

³²⁵ *Id.*

³²⁶ *Id.*

managers, directors, and less support in the academy.³²⁷ As a matter of positive theory, however, the entity model is more consistent with the managerial concept of the corporation, which allows managers leeway to consider nonshareholder interests: “[It] has, in fact, dominated the real world of business and politics since the great depression.”³²⁸ According to at least three current or former Delaware jurists, Leo Strine, Jack Jacobs, and William Allen, who have participated in the scholarly debate, Delaware corporate law is founded on the entity model of the corporation.³²⁹

Shareholder primacy is a logical extension of the theory of agency cost.³³⁰ This argument constructs a principal-agent model of the firm, and the argument goes as follows. The firm is seen as a nexus of contract claims.³³¹ Creditors and employees negotiate and contract directly with the managers representing the firm, and thus they can adequately protect their interests.³³² Shareholders do not have the benefit of such explicit contracts and yet they are the most vulnerable to risk because they hold the residual claim.³³³ Corporate agents thus should be obligated to maximize profit.³³⁴ But agents, who control corporate assets, may not do this because they are also subject to their individual interests in the firm.³³⁵ If so, it is said that an agent held accountable to two or more principals will confront conflicting interests in serving them and in the end these interests serve only to excuse behavior that promotes only the agent’s interest.³³⁶ Frank Easterbrook and Daniel Fischel explain: “Faced with a demand from either group, the

³²⁷ Allen et al., *The Great Takeover Debate*, *supra* note 6, at 1075-76.

³²⁸ Allen, *supra* note 312, at 1403.

³²⁹ See Leo E. Strine, Jr., *The Social Responsibility of Boards of Directors and Stockholders in Change of Control Transactions: Is There Any “There” There?*, 75 S. CAL. L. REV. 1169, 1176 (2002) (“[T]he entity model prevails”); Allen et al., *The Great Takeover Debate*, *supra* note 6, at 1079 (“ . . . Delaware law inclines toward the entity model”); ALLEN ET AL., *supra* note 138, at 296 (“To whom do directors owe loyalty? The short answer is that they owe their duty to the corporation as a legal entity.”). See also *N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla*, 930 A.2d 92, 101 (Del. 2007) (noting that fiduciary duty is to the corporation and that shareholders have standing to bring derivative action on behalf of the corporation).

³³⁰ The shareholder primacy norm means a standard based on an expectation, created by social, legal, or ethical considerations that corporate agents should act primarily in the best interest of shareholders, who are assumed to want maximum profit. See D. Gordon Smith, *The Shareholder Primacy Norm*, 23 J. CORP. L. 277, 278 (1998).

³³¹ EASTERBROOK & FISCHEL, *supra* note 244, at 22-25.

³³² See *id.* at 50 (arguing that with respect to limited liability “there is no externality with respect to voluntary creditors”); Robert B. Thompson, *Unpacking Limited Liability: Direct and Vicarious Liability of Corporate Participants for Torts of the Enterprise*, 47 VAND. L. REV. 1, 12 (1994) (“[F]ew question the shifting of these risks when creditors voluntarily deal with the limited liability enterprise.”). See also *Simons v. Cogan*, 542 A.2d 785, 788 (Del. Ch. 1987) (holding that fiduciary duty does not inure to the holders of convertible debt).

³³³ EASTERBROOK & FISCHEL, *supra* note 244, at 22-25.

³³⁴ *Id.* at 36-39.

³³⁵ *Id.* at 38.

³³⁶ *Id.* See generally Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976) (advancing a theory of agency cost).

manager can appeal to the interests of the other. Agency costs rise and social wealth falls.”³³⁷ Fidelity to the shareholder pecuniary interest may produce bad effects. But if a political society wishes to change the net effects of corporate behavior, it can do so in one of two ways, by changing either the prices of the activity or the structure of the firm.³³⁸ Given this choice, the shareholder primacy norm requires that society should alter economic incentives to produce the desired effects while leaving intact the wealth-maximizing principles built into the firm.³³⁹

Any theory of the firm must recognize the paramount importance of economic productivity, global competitiveness, and societal wealth.³⁴⁰ So pervasive are these concerns that “a more realistic and complex conception of corporations and corporate law could successfully be advanced only if it were premised on a plausible claim that such a model could lead to more productive organizations in utilitarian terms.”³⁴¹ The nexus of contracts theory (or property model) brings together the essential observations from the economic literature: those being, that a firm is cost efficient because it standardizes the contracting process, that agency cost should be mitigated, and that a firm is a private economic activity and not a social cause. The theory provides the intellectual framework for the idea that a firm should be seen not as a public asset or a concession from the state, but is instead an aggregate of private property rights held by constituents as specific contractual claims on its cash flow and assets.³⁴² In the legal academy, this property conception of the firm has garnered the greatest support.³⁴³ Recently, Henry Hansmann and Reinier Kraakman have declared “the end of history for corporate law” as they boldly declared the end of the debate: “[A]s a consequence of both logic and experience, there is convergence on a consensus that the best means to this end (that is, the pursuit of aggregate social welfare) is to make corporate managers strongly accountable to shareholder interests and, at least in direct terms, only to those interests.”³⁴⁴

³³⁷ EASTERBROOK & FISCHER, *supra* note 244, at 37-38. Others have argued that stakeholder theory is flawed because an organization must have a single objective. Multiple objectives leave corporate agents with no method for determining how to choose between them, should the conflict. This, the argument goes, leads to an increase in agency cost. See, e.g., Michael C. Jensen, *Value Maximization, Stakeholder Theory, and the Corporate Objective Function*, 12 BUS. ETHICS Q. 235, 237-38 (2002); Mark J. Roe, *The Shareholder Wealth Maximization Norm and Industrial Organization*, 149 U. PA. L. REV. 2063, 2065 (2001); Stout, *supra* note 214, at 1199-1200.

³³⁸ EASTERBROOK & FISCHER, *supra* note 244, at 37-38.

³³⁹ *Id.* at 37; Hansmann & Kraakman, *supra* note 214, at 441-42.

³⁴⁰ Allen, *supra* note 312, at 1406.

³⁴¹ *Id.*

³⁴² The lack of an internally consistent economic theory for what is essentially an economic activity diminishes the force of the stakeholder argument. MICHAEL C. JENSEN, *A THEORY OF THE FIRM: GOVERNANCE, RESIDUAL CLAIMS, AND ORGANIZATIONAL FORMS* 2 (2000); Hansmann & Kraakman, *supra* note 214, at 443-49.

³⁴³ Allen et al., *The Great Takeover Debate*, *supra* note 6, at 1075-76.

³⁴⁴ Hansmann & Kraakman, *supra* note 214, at 441.

The debate over shareholder primacy is the “most basic and arguably the most persistent controversy in corporate law.”³⁴⁵ However, an important aspect of this controversy has long been settled: outside of a narrow exception limited to the takeover realm,³⁴⁶ there is not a legally enforceable obligation to maximize shareholder profit. No serious person questions that firms should seek to earn profit through their activities, and shareholders, being residual interest holders, most often have the most to gain and risk. Most would accept as a starting point at least the importance of shareholders’ interest, perhaps a statement something along the lines of “a corporation should have as its objective the conduct of business activities with a view to enhancing corporate profit and shareholder gain.”³⁴⁷ Likewise, it is undeniable that corporate law, both statutes and case opinions, eschews the “ruthlessly narrow focus,”³⁴⁸ such as Milton Friedman’s famous proclamation that a corporation should “make as much money as possible while confirming to the basic rules of the society.”³⁴⁹ There is not a single case or statute that states something along the lines of “a board has a fiduciary duty to solely maximize shareholder profit in managing the firm as a going concern.” The closest statement of a legal obligation was made in the famous case of *Dodge v. Ford Motor Co.*³⁵⁰ “A business corporation is organized and carried on primarily for the profit of the stockholder. The powers of the directors are to be employed for that end.”³⁵¹ But this 1919 decision of the Michigan Supreme Court, found in most corporate law casebooks, is famous because it is an outlier.³⁵² Under

³⁴⁵ Allen et al., *The Great Takeover Debate*, *supra* note 6, at 1071. See also Adolf A. Berle, *Corporate Powers as Powers in Trust*, 44 HARV. L. REV. 1049 (1931) (corporate agents exercise power “only for the ratable benefit of all the shareholders as their interest appears”); E. Merrick Dodd, *For Whom Are Corporate Managers Trustees?*, 45 HARV. L. REV. 1145, 1148 (1932) (the corporation “has a social service as well as a profit-making function.”).

³⁴⁶ The most prominent exception is in the takeover context of a cash buyout, under which board of directors is under a fiduciary duty to maximize shareholder profit. *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 182 (Del. 1986). See also *Paramount Commc’ns, Inc. v. QVC Network, Inc.*, 637 A.2d 34, 48 (Del. 1994) (holding that absent the takeover context, directors are not obligated to maximize shareholder wealth).

³⁴⁷ AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 2.01(a) (1994). The ALI “makes clear that certain kinds of conduct must or may be pursued . . . even if the conduct either yields no economic return or entails a net economic loss.” *Id.* cmt. f.

³⁴⁸ Allen et al., *The Great Takeover Debate*, *supra* note 6, at 1083.

³⁴⁹ Milton Friedman, *The Social Responsibility of Business is to Increase its Profits*, N.Y. TIMES, Sept. 13, 1970, § 6 (Magazine), at 32-33. Delaware has rejected a hard-line view of shareholder primacy. See *Time, Inc.*, 571 A.2d at 1150 (“[A] board of directors . . . is not under any per se duty to maximize shareholder value . . .”). See also Stout, *supra* note 214, at 1204 (“Delaware courts seem to have come down rather firmly on Dodd’s side of the Berle-Dodd debate.”).

³⁵⁰ 170 N.W. 668. (Mich. 1919).

³⁵¹ *Id.* at 684.

³⁵² See Robert J. Rhee, *Corporate Ethics, Agency, and the Theory of the Firm*, 3 J. BUS. & TECH. L. 309, 321 (2008) (not that the case is “a novelty”); Blair & Stout, *supra* note 316, at 301 (noting that the case

the business judgment rule, directors who consider stakeholder interest and sacrifice profit, like directors who dispense with these considerations and instead maximize profit, will be insulated from liability.³⁵³ The persistent controversy concerns the norm of shareholder primacy, an unenforceable prescription that the primary purpose of a corporation should be to maximize the shareholder's wealth.³⁵⁴

With this understanding of the theory of the firm and shareholder primacy, the object lesson of the Bank's acquisition of Merrill is that the shareholder primacy norm can conflict with the broader goal of enhancing aggregate social welfare or wealth. It is perhaps undeniable that the interests of the firm, shareholders, and the public are aligned in preserving the financial markets. If, however, current shareholders could have gained at the expense of exacerbating a financial catastrophe, a clear net loss in the cost-benefit analysis, the board was empowered to prevent such catastrophe by assuming private loss for the greater public gain. As a normative matter, such expansive authority should be proper, and as a positive matter, such authority can be found in Delaware corporate law.

This thesis is consistent with the animating principle of corporate law—that is, corporate law is founded on the principle of social wealth maximization.³⁵⁵ This principle is not the same as shareholder profit maximization, which at its essential level is a distributive concern.³⁵⁶ Scholars have observed that there are numerous anomalies inconsistent with the principal-agent model, and they hint at the possibility that the prevailing model of corporate law may need a paradigm shift.³⁵⁷ Shareholder primacy is a default norm only, and it can be subjugated to the interests of other constituents.³⁵⁸ For instance, many states have constituency statutes that permit the board to consider the interests of nonshareholder interests.³⁵⁹ We have also seen two other anomalies: the specific power to provide both gifts and government aid. Both provisions

is “highly unusual”); ALLEN ET AL., *supra* note 138, at 298 (“Thus, *Dodge v. Ford Motor Co.* is unique precisely because Mr. Ford announced that he was acting in the interests of nonshareholders.”).

³⁵³ BAINBRIDGE, *supra* note 215, at 414.

³⁵⁴ Henry T.C. Hu & Jay Lawrence Westbrook, *Abolition of the Corporate Duty to Creditors*, 107 COLUM. L. REV. 1321, 1358 (2007) (“Academic commentary typically assumes that there is a legally enforceable duty to maximize shareholder wealth. In fact, apart from certain very narrow takeover contexts, judges have refrained from mandating an overarching duty to maximize share prices.”).

³⁵⁵ ALLEN ET AL., *supra* note 138, at 2.

³⁵⁶ *See id.* at 296 (noting that shareholder interest may conflict with the interests of other constituents). Even strong proponents of shareholder profit maximization do not suggest that profit and social welfare are perfectly aligned. EASTERBROOK & FISCHER, *supra* note 244, at 39.

³⁵⁷ *See* Margaret M. Blair & Lynn A. Stout, *Specific Investments: Anomalies in Corporate Law*, 31 J. CORP. L. 719 (2006).

³⁵⁸ *See* ALLEN ET AL., *supra* note 138, at 295 (noting that shareholder primacy “has not fully eclipsed . . . the view that directors must act to advance the interests of all constituencies in the corporation, not just the shareholders”).

³⁵⁹ *See* Subramanian, *supra* note 308, at 1827-28.

authorize the board to inflict financial loss on the corporation through the provision of assets to third-parties without consideration.

There are other examples of the subordination of shareholder primacy to a normatively superior principle. A prominent example is the now well-established doctrine allowing a board to pivot its fiduciary obligation from shareholders to creditors in insolvency. A board's fiduciary obligation ordinarily runs to the corporation and shareholders.³⁶⁰ In the seminal case *Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp.*,³⁶¹ Chancellor Allen articulated an exception: "At least where a corporation is operating in the vicinity of insolvency, a board of directors is not merely the agent of the residu[al] risk bearers, but owes its duty to the corporate enterprise."³⁶² This means that the board has "an obligation to the community of interest that sustained the corporation, to exercise judgment in an informed, good faith effort to maximize the corporation's long-term wealth creating capacity."³⁶³ In the vicinity of insolvency, the shareholder interest in the firm begins to mimic the interest of option holders in the sense that their value is increased when the riskiness of the firm's cash flow increases, though such risk-taking diminishes the overall value of the enterprise, that is, the sum of the equity and credit claims.³⁶⁴ Under these circumstances, "the corporation's long-term wealth creating capacity" is realized only if directors "are capable of conceiving of the corporation as a *legal and economic entity*."³⁶⁵

³⁶⁰ See, e.g., *N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla*, 930 A.2d 92, 101 (Del. 2007) ("[D]irectors must continue to discharge their fiduciary duties to the corporation and its shareholders by exercising their business judgment in the best interests of the corporation for the benefit of its shareholder owners.")

³⁶¹ No. 12150, 1991 WL 277613 (Del.Ch. 1991), *reprinted in* 17 DEL. J. CORP. L. 1099 (1992).

³⁶² *Id.* at *34.

³⁶³ *Id.*

³⁶⁴ In his famous footnote, Chancellor Allen demonstrated this proposition. *Id.* at 1155-56 n.55. The hypothetical goes like this. A corporation has a single asset, a judgment of \$51 that is currently on appeal. Its liability is to creditors of \$12. The probability on appeal is: 25 percent affirmance, 70 percent modification of judgment to \$4, and 5 percent reversal. The expected value of the judgment is \$15.55. The equity value of the firm is \$3.55 (= \$15.55 - \$12). Any settlement above \$15.55 will increase the value of the firm. Assume a settlement offer of \$17.5 is made. Creditors will want to accept because it assures payment, and there is even \$5.5 left over for shareholders. But shareholders will not want to settle. They will want to pursue the appeal because it has a higher expected payoff to them. They have a 25 percent chance of a payoff of \$39 (= \$51 - \$12), which is an expected residual value of \$9.75. This sum is substantially greater than the \$5.5 that would be left over from a settlement at \$17.5. The point is that under certain circumstances, shareholders may be incentivized to diminish the value of the firm (in this case, a rejection of a settlement offer in excess of the enterprise value). This example shows that when the shareholder's interest is essentially reduced to the option value of equity, the shareholder has an incentive to increase the riskiness of the firm's anticipated cash flow, even though such risky decisions may reduce the enterprise value of the firm. See Robert J. Rhee, *The Effect of Risk on Legal Valuation*, 78 U. COLO. L. REV. 193, 201-07 (2007) (discussing the difference between asset pricing and option pricing).

³⁶⁵ *Credit Lyonnais*, No. 12150, 1991 WL 277613, at *34 (Del.Ch. 1991), *reprinted in* 17 DEL. J. CORP. L. at 1155-56 n.55 (emphasis added).

Subsequently, the Delaware Supreme Court adopted the principle that fiduciary duty can shift to creditors, but modified the trigger to actual insolvency.³⁶⁶ In so ruling, the court made the commonsensical observation that “[w]hen a corporation is *insolvent*, however, its creditors take the place of the shareholders as the residual beneficiaries of any increase in value.”³⁶⁷

The doctrine of fiduciary duty to creditors played an important role in the recent financial crisis. During the negotiation over the acquisition of Bear Stearns, Jimmy Cayne, a Bear Stearns board member, threatened to throw the company into bankruptcy rather than accept a low bid offer from JPMorgan Chase.³⁶⁸ This “nuclear card” was a calculated game of brinkmanship with the federal government, the stakes being either a federal bailout of Bear Stearns, which would then remain independent, or a collapse of the firm with potentially worldwide financial fallout.³⁶⁹ Among other considerations, Cayne recognized that the claim to the primary value of the firm resided with bondholders, who owned approximately \$70 billion of the firm’s debt; recognizing that the coordinated JPMorgan-federal government rescue of Bear Stearns was a bailout of creditors, he attempted to negotiate some distribution of their value to shareholders.³⁷⁰ The tactic of holding hostage the economic interest of the firm as a whole is not unheard of,³⁷¹ only the stakes here concerned the global financial market. Ultimately, independent board members persuaded Cayne and Bear Stearns manager that the option was unthinkable.³⁷² Their primary concern shifted to bondholders and other interested constituents including employees.³⁷³ Indeed, during the board meeting to decide whether to accept JPMorgan

³⁶⁶ *Gheewalla*, 930 A.2d at 101.

³⁶⁷ *Id.*

³⁶⁸ COHAN, *supra* note 16, at 91, 103-06. Cayne was a prominent shareholder, former CEO of Bear Stearns, and a Wall Street legend. He was quoted as ruminating out loud: “I knew that there was very strong probability that if Bear Stearns went down, there might be systemic failure. I knew I had a nuclear card. But you can’t play it If anybody on earth would have played it, it would have been me.” *Id.* at 91. At the time, Cayne owned approximately six million shares, which at their height had been worth more than \$1 billion. *Id.* At \$10 per share, this value was reduced to approximately \$60 million.

³⁶⁹ *Id.* at 91.

³⁷⁰ *Id.* at 104.

His finger moved back over the red button. He wondered if the firm’s bondholders, who together held \$70 billion of debt and who in a merger with JPMorgan would be made whole but in bankruptcy would be severely impaired, should be asked to make a contribution to the shrinking pie for shareholders As Cayne knew, the bondholders had by far the most to gain from a deal with JPMorgan.

³⁷¹ *See, e.g., Orban v. Field*, No. 12820, 1997 WL 153831, at *8 (Del. Ch.) (“A board may certainly deploy corporate power against its own shareholders in some circumstances—the greater good justifying the action—but when it does, it should be required to demonstrate that it acted both in good faith and reasonably.”).

³⁷² COHAN, *supra* note 16, at 106.

³⁷³ *Id.* at 106-09.

Chase's acquisition offer, Bear Stearns's legal adviser, Sullivan & Cromwell, advised the board that under Delaware law its fiduciary duty had shifted to creditors and other interest groups such as employees.³⁷⁴ Imagine that in the heat of the moment and in a desperate gamble to increase shareholder wealth, the "nuclear card" was played. What would have been the consequences on the wealth of the corporate enterprise and the welfare of the public? The Bear Stearns episode vividly demonstrates Chancellor Allen's rationale in *Credit Lyonnais*.

Although the concept of fiduciary duty to creditors has been sharply criticized in scholarly literature,³⁷⁵ there is a well founded, core principle at work. Shareholder primacy is simply a default rule for social wealth maximization. Since shareholders hold the residual economic claim to the corporation's assets, director accountability as measured by shareholder benefit has the effect of enhancing the entire value of the enterprise as a whole economic entity. The thought is that shareholder primacy is based on efficiency consideration. However, maximizing shareholder value is not ipso facto a superior proposition. The proposition fails when the shareholders' claim is viewed as an out-of-the-money call option.³⁷⁶ Intrinsic in the concept of shareholder value is a distributive quality.³⁷⁷ Stated simply, it is fairly obvious that shareholder wealth can increase in only three distinct ways: (1) the total size of the wealth created by the enterprise increases, thus leaving a greater residual claim for the shareholders; (2) the economic pie remains the same, but shareholders take a greater portion than other claimants; and (3) shareholders increase their wealth by taking action that reduces the size to the economic pie, thus diminishing the aggregate returns to other claimants.³⁷⁸

Only the first proposition increases social wealth and is thus a normatively superior outcome.³⁷⁹ The second proposition is neutral as to social wealth, and the matter concerns only the equity of distribution. For instance, if we assume that there are no externalities, society should not care that employees of Goldman Sachs take approximately 50 percent of net revenue of the firm and shareholders only 10 percent, such an arrangement being the private contractual arrangement achieved among the

³⁷⁴ *Id.* at 108-09.

³⁷⁵ See, e.g., Hu & Westbrook, *supra* note 323, at 1341-43. See also Conference, *Twilight in the Zone of Insolvency: Fiduciary Duty and Creditors of Troubled Companies*, 1 J. BUS. & TECH. L. 229 (2007).

³⁷⁶ See *supra* text accompanying note 358.

³⁷⁷ Robert J. Rhee, *Bonding Limited Liability*, 51 WM. & MARY L. REV. 14 (forthcoming 2010), available at

http://digitalcommons.law.umaryland.edu/cgi/viewcontent.cgi?article=1788&context=fac_pubs.

³⁷⁸ *Id.*

³⁷⁹ See *id.* (arguing that limited liability is justified only on the basis of wealth creation and not cost externalization).

factors of production.³⁸⁰ In these circumstances, the law generally does not interfere in the contractual relationships establishing the distribution of the economic pie. It is said that enterprise law provides a set of default contract terms among factors of production. Absent fraud or some other bad motive, the contract terms govern and market forces primarily provide the pricing mechanism for these commercial relationships, including the market for corporate control if the shareholder slice is less than it should be.³⁸¹ The third proposition, a situation contemplated in *Credit Lyonnais*, is a clearly inferior proposition. The notion that shareholders are made wealthy by reducing the social wealth cannot be a desired goal. To be sure, this effect is seen, perhaps frequently, as is the case when limited liability is used as an ex ante liability avoidance scheme.³⁸² Would any efficient or just society provide a shield against liability if it had perfect information and knew beforehand that a firm would impart social cost for which its assets cannot pay? Such a society would be economically and morally bankrupt. A rule promoting a reduction in the aggregate social wealth is inefficient and can be justified only on the illicit premise that a specific class of capital providers has an entitlement to their wealth maximization at a larger cost to society.

The rule of fiduciary duty to shareholders reflects the view that creditors are adequately protected through contractual agreements, fraud and fraudulent conveyance law, implied covenants of good faith and fair dealing, bankruptcy law, general commercial law, and other creditor rights.³⁸³ On the other hand, shareholders can only be legally protected through statutory corporate law and common law-based fiduciary duty.³⁸⁴ The fair assumption is that this scheme of legal protection for creditors and shareholders tends to increase enterprise value, and thus fiduciary duty to shareholders is considered a superior default norm. This assumption, however, is only a default. As the Delaware courts have noted, there are

³⁸⁰ See *supra* note 253. Of course, society cares greatly about executive compensation because there are negative externalities arising from perverse incentives, erosion of trust and inefficient allocation of corporate resources. The financial crisis is a prime example.

³⁸¹ See Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110 (1965). But market mechanisms can break down. "Having gained control of the board, top management may decide that collusion and expropriation of security holder wealth are better than competition among themselves." Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288, 293 (1980).

³⁸² See, e.g., *Mull v. Colt Co.*, 31 F.R.D. 154 (S.D.N.Y. 1962) (taxi enterprise partitioning assets to avoid liability); *Walkovszky v. Carlton*, 223 N.E.2d 6 (N.Y. 1966) (same).

³⁸³ *N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla*, 930 A.2d 92, 99 (Del. 2007).

³⁸⁴ Of course, shareholders can also exercise the "Wall Street rule" and sell shares if the corporation is not providing an adequate return. In this way, there is competition for equity capital that always keeps the attention of the directors on profitability. See Barnali Choudhury, *Serving Two Masters: Incorporating Social Responsibility into the Corporate Paradigm*, 11 U. PA. J. BUS. L. 631, 670 (2009) (discussing the "Wall Street rule" as "the classic limit on management's ability to deviate from profit goals").

special circumstances where shareholder profit maximization can result in the diminished enterprise value.³⁸⁵ The rule of fiduciary duty to creditors addresses the special situations where shareholders would maximize their profit only by reducing the enterprise value of the firm.

The common principle binding the two rules of fiduciary duty is social wealth maximization. The more accurate measure of the value of a firm is enterprise value, the economic pie available to all capital providers.³⁸⁶ Shareholder primacy is highly correlated to the principle of wealth maximization, and this correlation is the basis for the normative foundation of shareholder primacy. But the correlation is not perfect, and shareholder primacy is essentially a distributive principle concerning the return to only one class of capital providers. To the extent that the shareholder primacy undermines the normative goal of social wealth enhancement, that norm is subjugated.³⁸⁷

Another prominent principle of social wealth maximization is the concept of limited liability. Its purpose is not to facilitate liability avoidance and risk externalization; rather, limited liability is justified because its many benefits outweigh the cost of risk externalization.³⁸⁸ These benefits are well known.³⁸⁹ In short, limited liability decreases the cost of monitoring managers and other shareholders, increases the liquidity of shares, promotes diversification, and incentivizes managers to pursue positive net present value projects.³⁹⁰ These combined effects increase the value of the firm in several ways. They reduce agency cost and the cost of capital.³⁹¹ The cost of equity is reduced when shares are freely alienable and there is a liquid market.³⁹² The cost of debt is also lowered because limited liability reduces transaction cost of credit by providing a standard default contract term.³⁹³ These cost savings can then be directed toward the

³⁸⁵ See *supra* text accompanying note 358.

³⁸⁶ “[I]ndividuals are as well off as possible if they maximize their wealth as measured by the discounted present value of all future claims.” Michael C. Jensen, *Value Maximization, Stakeholder Theory, and the Corporate Objective Function*, 14 J. APPLIED CORP. FIN. 8, 13 (2001).

³⁸⁷ See *supra* text accompanying note 352.

³⁸⁸ Rhee, *supra* note 371, manuscript at 8-9..

³⁸⁹ See EASTERBROOK & FISCHER, *supra* note 244, at 41-47 (providing litany of well recognized justifications). See also BAINBRIDGE, *supra* note 215, at 132-51; Paul Halpern et al., *An Economic Analysis of Limited Liability in Corporation Law*, 30 U. TORONTO L.J. 117, 118 (1980) (listing some long-recognized economic benefits of limited liability corporations and claiming that, no matter the status of the law, companies practice some form of limited liability by common consent).

³⁹⁰ EASTERBROOK & FISCHER, *supra* note 244, at 41-44.

³⁹¹ See *id.* at 41-47 (listing ways in which limited liability corporations decrease the need to monitor agents and reduce the cost of monitoring shareholders, and discussing how limited liability corporations reduce the cost of capital by distributing risk more efficiently).

³⁹² See *id.* at 42-43.

³⁹³ See *id.* at 43.

economically productive activities of the firm.³⁹⁴ Thus, limited liability is economically efficient and increases social wealth.

The criterion used to determine corporate law's efficiency is important. Efficiency is based on the Kaldor-Hicks criterion, which is distinguished from the Pareto superior efficiency. The Pareto superior criterion states that a change is efficient if at least one person is made better off and no person is made worse off.³⁹⁵ This criterion has few practical applications because transactions often have third-party effects and the cost of bringing about compensation may often exceed the net surplus.³⁹⁶ In contrast, Kaldor-Hicks efficiency provides that a change is efficient if gainers gain more than the losers lose.³⁹⁷ The important concept is that in principle the gainers could compensate the losers and still enjoy a surplus, but compensation is not required.³⁹⁸ "In other words, efficiency corresponds to 'the size of the pie,' while equity has to do with how it is sliced."³⁹⁹ This is essentially a cost-benefit analysis,⁴⁰⁰ which has greater practical application than the Pareto superior criterion. Thus, Kaldor-Hicks efficiency "has become a standard tool for evaluating enterprise law."⁴⁰¹

A cost-benefit analysis is the governing principle of corporate law.⁴⁰² Society has a normative preference for greater aggregate wealth.⁴⁰³ The Kaldor-Hicks criterion provides a simple, compelling animating principle for the default norm of shareholder primacy, the pivot of fiduciary duty to creditors, and the rule of limited liability. These rules tend to increase social wealth: shareholder primacy, because it directs managers to create residual profit; fiduciary duty to creditors, because shareholders are incentivized to destroy firm value when their economic claim resembles an out-of-the-money call option rather than a true residual claim; limited liability, because it creates value even though it externalizes the cost of torts. Together, these doctrines constitute a coherent picture that shareholder primacy, like the business judgment rule, is merely a presumption, albeit a fairly strong one.⁴⁰⁴ The distributive principle of

³⁹⁴ See *id.* at 44 ("The increased availability of funds for projects with positive net values is the real benefit of limited liability.").

³⁹⁵ ROBERT COOTER & THOMAS ULEN, *LAW & ECONOMICS* 47 (5th ed. 2008);

³⁹⁶ See POSNER, *supra* note 304, at 13 (stating that most policy analysis is done under the Kaldor-Hicks standard).

³⁹⁷ See *id.*

³⁹⁸ See *id.*

³⁹⁹ A. MITCHELL POLINSKY, *AN INTRODUCTION TO LAW AND ECONOMICS* 7 (3d ed. 2003).

⁴⁰⁰ COOTER & ULEN, *supra* note 387, at 47.

⁴⁰¹ ALLEN ET AL., *supra* note 138, at 5.

⁴⁰² See *id.* at 3-4.

⁴⁰³ *Id.* at 2.

⁴⁰⁴ See *id.* at 296 ("When a solvent corporation pursues its regular business activities, the interests of its management, creditors, employees, and stockholders are largely congruent with the interests of its equity investors.").

shareholder primacy is not the end of corporate law, but is instead a default setting because in most cases profit maximization nicely correlates to increased social wealth.⁴⁰⁵ The default setting can change when the social cost-benefit calculus changes. In the face of clear evidence of the threat of abnormally large social harm associated with a national crisis, the board can subjugate shareholder primacy, which even in normal times is an unenforceable norm, to directly advance the societal interest preventing or mitigating such harm.

The financial crisis of 2008 teaches us that the cost-benefit analysis does not always weigh in favor of private financial gain. Indeed, much of its causality can be explained by the pursuit of short-term private gain by employees, managers, and vicariously passive shareholders of the many firms responsible for the crisis.⁴⁰⁶ In ordinary circumstances, the framing of shareholder primacy is not at issue, and we correctly assume that the profit-maximizing firm with its embedded distributive principle generally tends to enhance social wealth and welfare because the legal process is ill-suited to engage in an individualized assessment of the cost-benefit and distribution of surplus to the various participants and constituents.⁴⁰⁷ The rising tide of shareholder wealth lifts all boats, it is correctly assumed as the default aspiration. The incentive structure underlying profit maximization works most of the time in ordinary circumstances.⁴⁰⁸ This default setting, however, should not diminish society's greater interest in the protection of the financial markets and the national economy, or the public good more generally in time of great crises. These interests can outweigh the narrow financial interests of any single firm since a sound economy and market are preconditions to the long-term health of the company.

⁴⁰⁵ The observation of William Allen, Reinier Kraakman, and Guhan Subramanian in their casebook provides a succinct statement of this concept.

The "corporation" has multiple constituencies with conflicting interests, including stockholders, creditors, employees, suppliers, and customers. To say that directors owe loyalty to the corporation masks conflicts among these constituencies. Happily, in most cases, these conflicts can be reconciled in practice. When a solvent corporation pursues its regular business activities, the interests of its management, creditors, employees, and stockholders are largely congruent with the interests of the equity investors. Thus, it makes no difference whether managers think of themselves as furthering long-term shareholder interests or furthering a multiconstituency interest in long-term corporate welfare.

Id. at 296.

⁴⁰⁶ See Rhee, *supra* note 11, at 618-20 (explaining that Bear Stearns, Lehman Brothers, and Merrill Lynch became distressed because of poor risk management and short-term focus on profitability).

⁴⁰⁷ ALLEN ET AL., *supra* note 138, at 296 ("When a solvent corporation pursues its regular business activities, the interests of its management, creditors, employees, and stockholders are largely congruent with the interests of its equity investors.").

⁴⁰⁸ See *id.*

The specific set of complex considerations confronted by the Bank's board was not the first. Consider the assessment of Jamie Dimon, JPMorgan Chase's CEO, regarding the Bear Stearns acquisition.

The import of this massive direct intervention to save a securities firm from failing was historic. Yet there was little choice, the key participants felt at the time, "People were saying, 'you have to save them, you're JPMorgan!'" Dimon remembered. "It was a wise thing to do . . . JPMorgan should not stand in the way of doing something good because we're being selfish or parochial." He later clarified his thinking. "My perspective, from the start," Dimon explained, "was that we could not do anything that would jeopardize the health of JPMorgan. That would not be good for our shareholders and it would not be good for the financial system. But I also felt that, to the extent it was consistent with the best interests of shareholders, we'd do everything we reasonably could to try to prevent the systematic damage that the Bear Stearns failure would cause. We and the whole board—we, the management team, and the whole board of the company—viewed that as an obligation of JPMorgan as a responsible corporate citizen."⁴⁰⁹

To be sure, this comment may be self-promoting, but also it also illustrates candor by a CEO who was in a position of awesome responsibility during a national crisis. We see in this nuanced, perhaps conflicting, comment that the consideration of a board and management during a financial crisis was a simplistic "What is good for shareholders?", but instead can be broader to include the perceived responsibility of a corporate citizen in a unique position to rescue a financial system. For a systemically-important financial institution, its interest in profit and society's interest in a sound market are intertwined; the board usually has the authority within the sphere of business judgment to weigh such a matter and decide accordingly without its decisions becoming subject to active judicial scrutiny. The alignment of interest, however, is certainly not perfect. There certainly could be situations when shareholder pecuniary interest conflicts with greater interest in social wealth and welfare. In these cases, the superior principle is one of maximizing the social wealth.

While Delaware law cannot mandate the pursuit of the public welfare, just as it cannot mandate shareholder profit maximization, without encroaching on the board's prerogative to manage the corporation, it leaves the board with great leeway to do precisely that. The business judgment rule protects board action within the bounds of rationality, and the board can rely on such half-fictional, abstractized reasoning as pursuing the "long-term" interest of the corporation and shareholders. Additionally, Delaware law provides broad flexibility in terms of the provision of corporate assets in times of national crisis through sections 122(9) and 122(12) of the DGCL. In crisis, fiduciary duty and board authority are elastic concepts sufficient to encompass the promotion of the public welfare

⁴⁰⁹ COHAN, *supra* note 16, at 98.

as the primary objective of action. Accordingly, the liability scheme should reflect this.

Despite the sometimes ideological nature of the defense of shareholder primacy, we also see that corporate decision making is much more complex than can be served by unconditional, bright-line rules or canons of economic or political philosophy. The Bank-Merrill episode is instructive. The Bank's board had many things to consider before determining whether to complete the merger with Merrill, including the potential harm to the financial markets and the public welfare in time of great crisis. This is no small consideration, and a systemically-important financial institution should have important obligations toward the soundness of the financial system. In this regard, the government acting through Paulson and Bernanke made sure that the board fully considered all important factors in its decision.

Lastly, the financial sacrifice made by the Bank under the "taking a bullet" scenario must be considered in the broader political and social context in which even a corporation must navigate. Consider these indisputable facts: financial institutions received unprecedented public aid during the financial crisis;⁴¹⁰ these firms bear a large responsibility for bringing about the financial catastrophe; inside these firms, many managers and employees are given large slices of the economic pie without any serious limitations imposed by corporate law, and such disbursements are made even when this class of professionals bears a large responsibility for the financial crisis. It is said that "legitimate political questions about, for example, the social distribution of wealth fall outside of the competence of corporate law."⁴¹¹ Yet, it would be an odd result of corporate law and our economic organization more broadly if corporate law is silent on whether these institutions can take voluntary action to save a financial system that begets the opportunity to create such vast wealth for their managers and employees as well as the broader society.

Consider a counterfactual scenario in which the Bank terminated its merger with Merrill, and thus exacerbated a financial market crash. In seeking to defend their action, Lewis and board announce in a press release that "the board acted consistent with its fiduciary duty to shareholders to protect their economic interests," or this idea becomes the public perception. A corporation's action to increase shareholder wealth irrespective to the

⁴¹⁰ See generally ZANDI, *supra* note 29, at 228-29 tbl. 12.3 (noting \$12 trillion of public funds committed as of March 2009).

⁴¹¹ ALLEN ET AL., *supra* note 138, at 2. See also EASTERBROOK & FISCHER, *supra* note 244, at 38 ("[S]ociety must choose whether to conscript the firm's strength (its tendency to maximize wealth) by changing the prices it confronts or by changing its structure so that it is less apt to maximize wealth. The latter choice will yield less of both good ends than the former."); Hansmann & Kraakman, *supra* note 214, at 442 ("[T]he most efficacious legal mechanisms for protecting the interests of nonshareholder constituencies . . . lie outside of corporate law.").

cost to society could have been the type of conscience-raising event that may trigger consequential backlash, like the accounting scandals at Enron and WorldCom that prompted the enactment of the Sarbanes-Oxley Act (“SOX”).

Shareholder primacy has little role in the government’s policy decision making. Even when the government is an investor in a bailout, it is myopic to believe that such public funds are deployed for the primary benefit of the shareholders in the firm. Any benefit to shareholders from government action was incidental toward the larger goal of stabilizing a collapsing economy. In a crisis, larger issues can be at stake than the wealth of shareholders. As discussed above, the board of a financial institution could also legitimately take a similar view. A board would have been well within its authority to consider the public welfare as the primary, albeit temporary, end of corporate action. Strong proponents of shareholder primacy would have little moral ground to stake an opposition. During the financial crisis, an unprecedented amount of public funds were deployed to support financial institutions. It is not so farfetched for a board to explicitly recognize a *quid pro quo*. In a national crisis, the provision of public funds may be advanced to benefit corporations, and similarly corporate resources can be deployed for the benefit of the public welfare, notwithstanding financial harm to the corporation and shareholders.

IV. POLITICS OF CRISIS AND GOVERNANCE

During national crises and in a federalist system like ours, the federal government has the primary obligation to address or coordinate the government’s response. Such response may include using federal resources, as well as coordinating the activities of others such as state and local governments, citizens, and perhaps even corporations. In this respect, the Bank-Merrill episode teaches a historic lesson: that is, while acting through its supervisory authority, the federal government can temporarily control the board’s function if it perceives that the board is potentially malfunctioning during a national crisis. This fact has important implication on the future design of substantive federal regulation of important industries, such as the financial, energy, pharmaceutical, and technology sectors.

In recent years, the federal-state dichotomy in corporate law has garnered much scholarly attention.⁴¹² For instances, Lucian Bebchuk and

⁴¹² See, e.g., Lucian A. Bebchuk & Assaf Hamdani, *Federal Corporate Law: Lessons from History*, 106 COLUM. L. REV. 1793, 1794-95 (2006); Kahan & Rock, *supra* note 270, at 1575; Mark J. Roe, *Delaware’s Politics*, 118 HARV. L. REV. 2491, 2494 (2005); Roe, *supra* note 278, at 591. See also Robert B. Thompson & Hillary A. Sale, *Securities Fraud as Corporate Governance: Reflections on Federalism*, 56 VAND. L. REV. 859, 860-61 (2003).

Assaf Hamdani have argued that state competition for corporate law inadequately protects investors and that a comprehensive, systematic review of federalization is needed.⁴¹³ Marcel Kahan and Edward Rock have argued that the federal-state relationship is symbiotic, and that the federal government intervenes in state law only in times of systemic change from significant populist sentiments.⁴¹⁴ Mark Roe has argued that Delaware law is subordinate to federal authority, so much so that it promotes federal policy, express or implied, or is otherwise preempted by federal law as was the case with the SOX.⁴¹⁵

Corporate law is as much a product of political calculation as it is of legal and economic deliberation.⁴¹⁶ Despite the divergence of opinions on the federal-state relationship and the federal preemption trigger, the ultimate power resides with the federal government as the entire field can be preempted.⁴¹⁷ State corporate law is not constitutionally guaranteed.⁴¹⁸ If state law undermines federal policy, state governments expose themselves to federal preemption,⁴¹⁹ something Delaware must consider.⁴²⁰

The failure of private corporate conduct during crises to promote national policy could be considered a failure of corporate law if the law is perceived to be a hindrance toward cooperation and assistance. For instance, assume that the Bank held the stability of the global financial system in its hands and it chose, per its legal right, to protect its parochial economic interest at the cost of triggering a collapse of the financial system and great harm to the national economy. Subsequently, documents are produced that the Bank engaged in a “Ford Pinto”-type cost-benefit analysis in justifying the board’s decision. What would be the consequences on the company, its board and management, and the financial industry sector? An appropriately outraged public and government may result in corrective legislation as was the case with the SOX, which was enacted in response to the accounting scandals at Enron, WorldCom, and other corporations. Private corporate governance cannot be insulated from public crisis management.

⁴¹³ Bebchuk & Hamdani, *supra* note 404, at 1794, 1798.

⁴¹⁴ Kahan & Rock, *supra* note 270, at 1576.

⁴¹⁵ Roe, *supra* note 278, at 591-93.

⁴¹⁶ *See generally id.*

⁴¹⁷ *See* Roe, *supra* note 278, at 633-34. *See also* U.S. CONST. art. VI, cl. 2.

⁴¹⁸ *See* Richard M. Buxbaum, *The Threatened Constitutionalization of the Internal Affairs Doctrine in Corporation Law*, 75 CAL. L. REV. 29, 34-36, 46-47 (1987) (criticizing the theory that the internal affairs doctrine has constitutional basis); Jed Rubinfeld, *State Takeover Legislation and the Commerce Clause: The “Foreign” Corporations Problem*, 36 CLEV. ST. L. REV. 355, 380-82 (1988) (same).

⁴¹⁹ *See* Bebchuk & Hamdani, *supra* note 404, at 1829 (“To be sure, some of the most extensive federal incursions were sparked by the collapse of the stock market or some other national crisis.”); Kahan & Rock, *supra* note 270, at 1576 (“[T]he possibility of federal preemption constitutes a threat to Delaware, but this threat is significant only in times . . . when systemic change is seen as generating a significant populist payoff.”); Roe, *supra* note 278, at 2528 (“National political forces, if powerful enough to temporarily overcome Delaware’s agenda-setting power, could also move the game to Washington.”).

⁴²⁰ *See generally* Roe, *supra* note 278.

In the Bank-Merrill episode, the government executed a temporary, indirect public takeover of corporate governance function when it appeared that the board would undermine federal policy.⁴²¹ The legal mess and increased systemic risk arising from an attempt to terminate the merger would have, in the words of Paulson, exhibited “a colossal lack of judgment.”⁴²² It was fortunate that this temporary, indirect takeover of board governance was possible because the federal government had the tool of bank supervisory authority. If the supervisory authority did not extend to a credible threat to fire the board and the management, the situation could have devolved to a board malfunction, and worse, the injection of more systemic risk into a badly damaged financial market.

Since the Merrill acquisition successfully closed, we are left with the question of whether a means of direct federal intervention in corporate governance is needed. The answer depends in part on whether the board would be found liable for its action. If liability arises from the board’s decision not to exercise the MAC, whether the option was viable or not, such liability would introduce uncertainty in future crises. The decision under state law would in effect undermine the authority of federal regulators and the legitimacy of their actions. In the next national crisis, rather than engaging in a cooperative relationship with the government, the board may exploit the crisis to pursue a narrow financial interest irrespective of any consequences to the public welfare, or at least it may be reluctant to make a sacrifice on behalf of the public welfare.

This possibility was openly discussed during congressional testimonies of Bernanke and Paulson. The potential for federal intervention in corporate law has already been recognized in congressional hearings. The following exchange between Bernanke and Representative Bill Foster is illustrative.⁴²³

Q. [Do] you believe that there are circumstances in which the CEO of a systemically important firm might be expected to have his shareholders take a bullet, to protect the overall health of the economy, in a crisis situation?

A. No, that’s not—that’s not appropriate under supervisory practice. And we have not done that.

⁴²¹ Clearly, the bailouts associated with the financial crisis resulted in direct government involvement in managerial decisions, such as the termination of executives and determination of appropriate compensation. *See, e.g.*, David Cho, *Banking*, WASH. POST, Apr. 24, 2009, at A16 (noting banks’ hesitancy to accept government bailout money because banks are wary of the government’s ability to restrict executive pay and make other managerial decisions).

⁴²² Paulson Prepared Testimony, *supra* note 86. As discussed, there is the possibility that Lewis never intended to invoke a MAC, and that he used the threat to cover up a poorly executed merger and secure federal financial aid for the Bank. *See supra* Part I.D.

⁴²³ Democrat, 14th District of Illinois; Member of House Committee on Oversight and Government Reform, and Subcommittee on Domestic Policy.

Q. Okay. And so do you believe that there is any need for any additional legal clarity about duties, of a CEO, to the shareholders, to the regulators and to the overall economy, in times of systemic crisis?

A. Well, that might be something for Congress to consider. But I think the rules as they currently stand are quite clear, that you can't force somebody to take actions, against the interest of their own company, for systemic reasons alone.⁴²⁴

Bernanke and Foster acknowledged that state corporate law may be ambiguous as to the fiduciary duty of the board and officers during a public crisis. Also, Bernanke's testimony must be parsed. The *government's* supervisory authority over financial institutions under federal banking law did not encompass forcing a company to make a financial sacrifice. This must be distinguished from the *board's* authority under state corporate law to take such action, and he left open the possibility of a federal safe harbor if the legal point is not already clear in state corporate law.

During Paulson's testimony, Representative Foster again inquired into the possibility of a federal safe harbor, and Paulson answered that "the more legal clarity we have the better" and that the issue while "very complicated . . . is certainly one I think that bears consideration."⁴²⁵ Later in his testimony, in response to the question of whether the government can fire the management and board of a bank, Paulson commented further:

I have an understanding that under unusual circumstances, if the Federal Reserve is dealing with a regulated entity and that there are decisions made at that regulated entity that endangers the safety and soundness of that institution, then the Fed has the authority to hold them accountable. Now, clearly in terms of corporate governance 101, we have—you know, we know how boards are selected and we know that boards select management. But there needs to be something for regulated entities where the regulators can protect the safety and soundness.⁴²⁶

Here, again, another federal regulator who was at the front line of the financial crisis expressed his view that greater clarity of board obligation and perhaps greater regulatory authority to elicit corporate cooperation may be needed through federal legislation.

The testimonies of Bernanke and Paulson suggest that there may be potentially counterproductive ambiguities in the understanding of a board's duty in times of crisis, and potential conflicts between the government's obligation to protect the public welfare and the board's duty under state corporate law. The Bank-Merrill episode bears this out. Only a legally unviable option to terminate the merger averted a true Hobson's choice between shareholder profit and public wealth and welfare. Banking supervisory authority was sufficiently broad to ensure that the board did not

⁴²⁴ Bernanke Testimony, *supra* note 86, at 16.

⁴²⁵ Paulson Testimony, *supra* note 86, at 36.

⁴²⁶ *Id.* at 40.

malfunction by selecting a legally reckless stratagem. In the future, the happenstance of the existence of regulatory power may be absent.

This leaves Delaware with an essential political calculation. If state corporate law is perceived to be inadequate, Congress may need to enact a federal safe harbor because private industry cooperation may be essential to advance important government and public welfare objectives in time of crisis. As discussed in Part II.B., a theory of fiduciary exemption can be justified by public necessity. Public necessity is a defense to a voluntary act of destruction or injury to property in response to a public crisis. It does not obligate the rescue of a person or situation.

Legislation can be more aggressive and may require a duty to rescue, at least among certain key industry sectors such as the financial, energy, technology, and pharmaceutical sectors. Here, there is another useful tort analogy. The general rule in tort law is that there is no duty to rescue.⁴²⁷ Only when there is a special relationship will courts sometimes impose an affirmative duty to rescue.⁴²⁸ The implication of these rules on corporate law is clear. It is inconceivable that state corporate law, either through statute or judicial ruling, would impose a duty to rescue the government or the public in a crisis. The duty to rescue is inconsistent with the philosophy of personal autonomy and liberty,⁴²⁹ and it would be inconsistent with the view of the corporation as primarily an aggregation of property rights.

To be clear, I do not advocate an affirmative duty to rescue. A shift from an informed, voluntary action of a board to a legal mandate for a rescue would swing the pendulum too far in favor of sacrificing private property for the public welfare. This is philosophically unpalatable. My theory of fiduciary exemption is based on the premise that a corporate board should and does have great authority to make informed decisions with the interest of all constituents in mind, including the greater public wealth and welfare, and this authority should be unchecked by legal constraints during the limited circumstance of a public crisis in which the firm is uniquely situated to avert a far greater harm at the cost of a private sacrifice. I simply raise the issue of a duty to rescue because it is not inconceivable that federal legislation could mandate a duty to rescue. The conditions necessary to enact the legislation would be a conscience-raising event during a public crisis, such as a “Ford Pinto”-type cost-benefit analysis or the mass perception of it. Additionally, certain companies or

⁴²⁷ See, e.g., *Yania v. Bigan*, 155 A.2d 343, 346 (Pa. 1959) (holding that there is no duty to rescue a drowning man).

⁴²⁸ See, e.g., *Tarasoff v. Regents of Univ. of Cal.*, 551 P.2d 334, 351 (Cal. 1976) (holding that a psychiatrist has a duty to warn the intended victim of a violent crime potentially perpetrated by his patient).

⁴²⁹ Epstein, *supra* note 302, at 198-203.

industries must be perceived to have a special relationship to the public welfare, and some obvious candidates are the financial, energy, technology, and pharmaceutical sectors.

CONCLUSION

The affairs of the corporation are considered private activity. The prevailing concept of the firm is a nexus of private contract rights among participants in an economic enterprise. These assertions undoubtedly have a certain descriptive power about them, but very little in law is categorical or axiomatic. In time of crisis, corporate activity can take the form of public-private activity, or at least it can impart significantly greater effects on social wealth and public welfare. In these situations, the normal rules do not apply. Just to be clear, this Article does not advocate corporate suicide or self-mutilation even as an aspirational matter. Crisis or not, there should be no such principle in corporate law requiring the impairment of a going concern. The thesis here is that there should be an exemption from the fiduciary principle when a board pursues the public good over the private gain on a temporary basis when the firm is uniquely situated to avert or mitigate a public crisis. If the cost-benefit analysis on a broader level is obvious, a board should be allowed to provide aid to the public without legal risk overhanging its decision.

The theory of fiduciary exemption may be controversial to strong proponents of shareholder primacy, but more radical, in my view, is a legal rule requiring a board to pursue private economic gain at a tremendous direct cost to society given the Hobson's choice when a board can avoid such cost through the provision of aid. In light of the unprecedented rescue of the private sector with public funds during the financial crisis, as may be expected when markets fail or a public crisis ensues, a legal rule that jeopardizes or deters a voluntary rescue would be morally suspect given the nexus of social relationships and the expectation of reciprocity of aid, which were evident in the financial crisis.

I am also comforted by two thoughts. First, the animating principle of corporate law is the maximization of social wealth and welfare, and not the more narrow interest of shareholder profit, which is essentially a distributive principle. In time of crisis, the benefit to the public may be so large and obvious that the presumption of shareholder primacy is clearly rebutted by the potential harm. The cost-benefit analysis may permit a primary obligation to consider the public good. Second, we are left with the plain fact that amidst a real, immediate, truly national economic crisis, shareholder pecuniary interest did in fact become rather incidental. It was clear at the time that the board of the Bank had many other considerations in its deliberation than shareholder profit maximization. In this episode, the legal relevance of the board's motivation may be moot because the

company may not have had a contractual option to avoid financial loss, but it shows how corporate decision making cannot be reduced to the mandate of enhancing firm value during a public crisis.

The real world can be more complex than the abstractions of principles or dogma devoid of context. Even if it could be shown that the Bank's shareholders would have financially gained from terminating the Merrill acquisition, the board would have been well within its authority to close the deal when the harm to the public's interest would have been great, and it should be allowed to do so publicly and without resort to such disingenuous elision as the "long-term interest of the corporation and shareholders." Such honesty may have the positive effect of recognizing that the corporate enterprise is integrated into the fabric of society rather than a separate, discrete nexus of contracts removed from the surrounding context and designed solely to maximize value for the residual claimant. Under the circumstance of a national crisis, courts should not penalize a board for acting in the interest of the public welfare as a matter of the practical politics between state and the federal governments, lest there be a potential federal response in the form of greater federal control of corporate governance either directly through a federal safe harbor or indirectly through the grant of more power to regulators.

The financial crisis of 2008 will not be the only national crisis. We can expect large crises in the future, though how they manifest is unpredictable. Perhaps the next crisis will be a large scale war, another economic collapse, a pandemic, or a large natural catastrophe. In these situations, the social wealth and public welfare should not be sacrificed upon the altar of shareholder primacy. Faith therein has its limits. Stated more bluntly, let us isolate the problem to its pure essence. Recall the hypothetical of the pharmaceutical company that sacrifices billions of dollars of profit in the face of a global flu pandemic and the resources of government is limited. The decision whether to sacrifice profit or take a financial loss is premised on three questions. First, can the board do this within current construct of corporate law? Yes, such authority is a part of the corporate contract. Second, should the board have the power to do this? Absolutely, along with the government, the corporation is the only entity that can muster enormous resources of society to aid in time of great crisis. Third, should the board do this? There is no easy answer. This is a business judgment of the board, absent some federal mandate through substantive regulation. In making this judgment, the board may take into account moral considerations, the exigencies of the human condition, and the common obligation of all members of society to care for each other on some essential level, in addition to the consideration of profit. In this difficult circumstance, such decisions based on public necessity are so great that the calculus should be free of legal risk. Thus, in a time of national crisis, the shareholder primacy norm can and sometimes does fail the stress test.