

# INDIVIDUAL OR COLLECTIVE LIABILITY FOR CORPORATE DIRECTORS?

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*Fiduciary duty is one of the most litigated areas in corporate law, and the subject of much academic attention, yet one important question has been ignored. Should fiduciary liability be assessed individually, where directors are examined one-by-one for compliance, or collectively, where the board's compliance as a whole is all that matters? The choice between individual and collective assessment can be the difference between a director's liability and her exoneration, affects how boards function, and informs the broader fiduciary duty literature in important ways. This article is the first to explore the individual/collective question and suggest a systematic way of approaching it. The article is both descriptive, in examining how some courts have answered this question (often implicitly), and normative, in asking whether the courts' tentative answer makes for good corporate governance policy.*

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## I INTRODUCTION

Efforts to improve corporate governance routinely focus on the board of directors, who enjoy almost unfettered control over the corporation.<sup>1</sup> Recognizing this “director primacy,”<sup>2</sup> policymakers, courts, and legal scholars constantly look for ways to improve board functioning, especially in the wake of scandals at Enron, WorldCom, and other corporations.<sup>3</sup> Making directors independent of management is a popular theme,<sup>4</sup> as are calls for subjecting directors to more robust fiduciary duties. Fiduciary duties are meant to serve as a check on director power

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<sup>1</sup> See Del. Code Ann. tit. 8 § 141(a) (2006) (“The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors...”).

<sup>2</sup> See Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. L. REV. 547 (2003).

<sup>3</sup> Jill E. Fisch, *Corporate Governance: Taking Boards Seriously*, 19 CARDOZO L. REV. 265, 265 (1997) (“Today’s corporate world is taking corporate governance and, in particular, the role of the board of directors, very seriously.”).

<sup>4</sup> Director independence is a defining feature of the Sarbanes-Oxley Act of 2002. Pub. L. No. 107-204 (codified in scattered sections of 15, 18 U.S.C.). Also, the NYSE and NASDAQ now require that listed companies have a majority of independent directors. For skepticism about the push toward director independence, see Sanjai Bhagat and Bernard Black, *The Uncertain Relationship Between Board Composition and Firm Performance*, 54 BUS. LAW. 921 (1999) (empirical study suggesting that greater director independence does not improve corporate performance, and that too many independent directors may actually hurt corporate performance); Donald C. Langevoort, *The Human Nature of Corporate Boards: Law, Norms, and the Unintended Consequences of Independence and Accountability*, 89 GEO. L.J. 797, 800 (suggesting director independence is not necessarily a good thing and that market and social forces should be allowed to determine the proper amount of director independence without legal mandates).

and to provide a means of reducing agency costs between shareholders and directors. Currently, however, fiduciary duties are a weak impetus for directors to act in the best interests of shareholders, at least to the extent that fiduciary law would seek to impose liability for director wrongdoing. This recognition has led some corporate law scholars to call for stricter fiduciary duties, which could take the form of an explicit duty to act in good faith<sup>5</sup> or a revival of the duty of care, which is now on life support.<sup>6</sup> Other corporate law scholars (and judging by the recent *Disney* case,<sup>7</sup> Delaware courts) take a more pessimistic view of fiduciary duty law as a potential cure for what ails boards, preferring to leave corporate governance to other devices, including market sanctions.<sup>8</sup>

The fiduciary duty literature is rich and fruitful, which makes it surprising that one important question within fiduciary law – a question that bears upon all the others – has been virtually ignored. Directors, of course, do not operate in isolation; they are only capable of acting by majority vote. In practice, they usually act unanimously.<sup>9</sup> Yet each

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<sup>5</sup> See Hillary A. Sale, *Delaware's Good Faith*, 89 CORNELL L. REV. 456, 494 (2004) (arguing in favor of an independent duty of good faith that has the “potential for addressing those outrageous and egregious abdications of fiduciary behavior that are not simply the results of bad process or conflicts”); Melvin A. Eisenberg, *The Duty of Good Faith in Corporate Law*, 31 DEL. J. CORP. L. 1, 27-31 (2006) (providing normative justifications for an independent duty of good faith).

<sup>6</sup> See Lisa M. Fairfax, *Spare the Rod, Spoil the Director? Revitalizing Directors' Fiduciary Duty Through Legal Liability*, 42 HOUS. L. REV. 393, 407-08 (2005) (observing with disfavor that “[o]ver the last twenty years, a variety of mechanisms have contributed to a virtual elimination of legal liability for directors who breach their duty of care”); Renee M. Jones, *Law, Norms, and the Breakdown of the Board: Promoting Accountability in Corporate Governance*, 92 IOWA L. REV. 105 (2006) (arguing in favor of due care liability calibrated by an individual director’s ability to pay); Cheryl L. Wade, *Symposium: Enron and Its Aftermath: Corporate Governance Failures and the Managerial Duty of Care*, 76 ST. JOHN’S L. REV. 767, 768 (2002) (“greater emphasis on standards of care for both directors and officers is warranted, especially in the aftermath of the corporate governance failures that scandalized Enron, WorldCom, and other large publicly held companies”).

<sup>7</sup> The *Disney* case, which spent the last several years bouncing between the Delaware Chancery and Supreme Courts, involved notably lax behavior on the part of Disney’s board of directors in the hiring and firing of president Michael Ovitz. Ovitz received an approximately \$140 million severance package for fifteen months work, and shareholders sued the directors alleging fiduciary duty breaches in connection with the payout. The directors were ultimately exonerated by both the Delaware Chancery Court and the Delaware Supreme Court. See *In re The Walt Disney Co. Derivative Litigation*, 2005 Del. Ch. LEXIS 113 (2005); *In re The Walt Disney Co. Derivative Litigation*, 2006 Del. LEXIS 307. This case is discussed in Section II.A.3.

<sup>8</sup> See, e.g., Larry E. Ribstein, *The Mandatory Nature of the ALI Code*, 61 GEO. WASH. L. REV. 985, 1027 (1993) (“A particularly questionable academic position...is that fiduciary duties, structures, and remedies must be imposed by law because market forces alone cannot eliminate agency costs.”).

<sup>9</sup> Bayless Manning, *The Business Judgment Rule and the Director's Duty of Attention: Time for Reality*, 39 BUS. LAW. 1477, 1489 (1984) (“Actions [of the board]

director is an individual, and each will either comply or not comply with the standards set by fiduciary law. For example, one director may have a conflict of interest, while the remaining board members do not. Also, different directors may have exercised different levels of carefulness in reaching their decisions. Given these differences (or potential differences) among directors, what impact does one director's fiduciary duty breach have on the liability of the remaining directors? Or, flipping the question, what impact does the compliance of the remaining directors have on the liability of the one breaching director? More broadly, the unexplored question within fiduciary duty law is how outcomes are affected when all directors vote the same way,<sup>10</sup> but some directors comply with their fiduciary duties while others do not. Should director liability be assessed individually or collectively?

An individual focus does not allow a director to hide behind her counterparts, but instead deems her singular breach of sufficient gravity to jeopardize the board's functioning and warrant legal sanctions. A collective focus, on the other hand, will serve to insulate any one director's wrongdoing provided the remaining directors complied with their fiduciary duties.<sup>11</sup> Therefore, how courts answer the

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are usually by consensus. If a significant sentiment of disagreement is sensed by the chairman, the matter is usually put over for later action, and sources of compromise and persuasion are pursued in the interim.”); James D. Cox and Harry L. Munsinger, *Bias in the Boardroom: Psychological Foundations and Legal Implications of Corporate Cohesion*, 48 LAW & CONTEMP. PROBS. 83, 91 (1985) (a “new board member is expected not only to work within the group’s collective views of the corporate interest, but also to cooperate with other board members in reaching decisions by group consensus”).

<sup>10</sup> Directors who vote against a particular course of action should be immune from liability. See *Francis v. United Jersey Bank*, 432 A.2d 814, 826 (NJ 1981) (“Usually a director can absolve himself from liability by informing the other directors of the impropriety and voting for a proper course of action.”); *Del. Code Ann. tit. 8 § 145* (2004):

Any director who may have been absent when [an unlawful dividend or stock repurchase] was done, or who may have dissented from the act or resolution by which the same was done, may be exonerated from such liability by causing his or her dissent to be entered on the books containing the minutes of the proceedings of the directors at the time the same was done, or immediately after such director has notice of the same.

The absentee director presents a more difficult case. Courts have held absentee directors liable for board decisions, although this is sometimes in the banking context where fiduciary duties are heightened. See *FDIC v. Bierman*, 2 F.3d 1424, 1433 (1993) (“The fact that an absentee director had no knowledge of the transaction and did not participate in it does not absolve him of liability.”); *Hoye v. Meek*, 795 F.2d 893 (10<sup>th</sup> Cir. 1986) (holding a semi-retired bank director liable for breaching his duty of care because he did not take affirmative steps to become informed about the actions of another director). For an example outside of the banking context, see the discussion of absentee-director O’Boyle’s liability in *Smith v. Van Gorkom*, *infra* note 25.

<sup>11</sup> See *infra* notes 87-91 and accompanying text.

individual/collective question has important practical ramifications. Although the choice between treating directors individually or collectively is only one of the variables in fiduciary duty suits, it has the potential to be the difference between a director's liability and her exoneration. As a result, it carries significant financial implications for directors, shareholders, insurers, and attorneys. Moreover, how courts answer the individual/collective question can affect how directors interact with one another, and can provide important insights into the judicial view of fiduciary duties as a corporate governance mechanism.

This article favors a duty-based answer to the individual/collective question on both descriptive and normative grounds. First, it will show that courts have generally focused on the board as a whole in duty of care cases, and on directors as individuals in duty of loyalty cases. Second, the article will argue that courts have been correct in drawing this duty-based distinction because it strikes the proper balance between the board's authority and its accountability in each case.<sup>12</sup> It contends that loyalty breaches, if committed by even a single director, are likely to impact the board's functioning in a meaningful way, and therefore those breaches warrant greater accountability though an individual director focus. On the other hand, due care breaches committed by only one director are unlikely to jeopardize the board's functioning in the same way, and therefore these breaches call for more deferential collective focus. Because good faith now appears to be a subset of the duty of loyalty,<sup>13</sup> and because it too involves intentional wrongdoing,<sup>14</sup> allegations of bad faith also warrant an individual director focus. Of course, corporate law cases do not always confine themselves to such tidy classifications, and this article should be read as proposing a general framework for analysis rather than hard-and-fast rules to cover every situation.

After contending that courts are properly oscillating between a collective and individual focus to director liability depending on the type of fiduciary duty at issue, this article asks what broader lessons we might take away from this. It suggests that this duty-based distinction reveals a further splintering between the duty of care and the duty of loyalty and a deemphasis on fiduciary duty liability as a corporate governance mechanism. On the other hand, that courts have only implicitly adopted the laxer collective approach in due care cases suggests that the duty of care is still important as an aspirational "standard of conduct," if not a "standard of liability."

This article proceeds as follows. Part II discusses the existing law on the collective versus individual treatment of directors in fiduciary duty

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<sup>12</sup> See *infra* Part III.A.1.

<sup>13</sup> After the Delaware Supreme Court's recent decision in *Stone v. Ritter*, 2006 WL 3169168, it appears settled that the duty to act in good faith is a subset of the duty of loyalty rather than an independent fiduciary duty. See *infra* Part III.B.1.b.

<sup>14</sup> See *infra* Part III.B.1.

suits. This law is comprised of cases that explicitly address the question, cases that implicitly address it, and statutes from Delaware and the Model Business Corporation Act (MBCA). Existing law reveals a preference for an individual director focus in duty of loyalty cases, and a preference for a collective focus in duty of care cases. Part III first sets forth the normative criteria that should inform the choice between the two assessment approaches on corporate governance policy grounds, and then applies those criteria to the different types of fiduciary duty claims that may be brought. It concludes that courts are creating good corporate governance policy through their duty-based distinction. Part IV draws broader implications about fiduciary duties from the courts' resolution of the individual/collective question. Part V concludes.

## II

### THE INDIVIDUAL/COLLECTIVE QUESTION: EXISTING LAW

Existing law on the individual/collective question is difficult to decipher. Forming any sort of a coherent picture about how the law views this question requires piecing together case law that explicitly addresses the question, case law that implicitly addresses it, and relevant statutory provisions from Delaware and the MBCA. Engaging in this exercise reveals an individual/collective focus that shifts depending on the type of fiduciary breach being litigated. Duty of loyalty claims tend to be analyzed using an individual approach, while duty of care claims tend to be analyzed using a collective approach.<sup>15</sup>

This section begins by examining three high-profile Delaware cases that have explicitly addressed the individual/collective question, albeit briefly and inadequately. It then touches on case law that could be said to implicitly answer the question. Finally, it introduces a Delaware statute and provision from the MBCA that speak to this question. While other statutes may also be relevant, the two provisions chosen for illustration are important provisions that provide support for the duty-based framework that emerges from the case law.

#### A. Cases Explicitly Addressing the Individual/Collective Question

##### 1. *Smith v. Van Gorkom*

The first of the three Delaware cases to explicitly address the collective versus individual treatment of directors in fiduciary duty suits

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<sup>15</sup> Roberta Romano makes this observation in discussing board stability. Roberta Romano, *Corporate Governance in the Aftermath of the Insurance Crisis*, 39 EMORY L.J. 1155, 1178 n. 39 (1990) (“A duty of care violation is likely to involve the entire board, whereas a duty of loyalty violation tends to be limited to directors (typically insiders) who have personally benefited from a transaction.”).

was the famous case of *Smith v. Van Gorkom*.<sup>16</sup> In that case, decided in 1985, the Delaware Supreme Court took the unprecedented step of holding all ten directors of Trans Union Corporation jointly and severally liable for \$23.5 million for breaching their duty of care in approving the sale of the corporation.<sup>17</sup> Trans Union's Chairman and CEO, Jerome Van Gorkom, orchestrated the sale with the help of another inside director, Bruce Chelberg. The remainder of the board was not informed of the proposal until the day before the buyer's deadline for accepting it.<sup>18</sup> The board approved the sale based on a twenty-minute presentation by Van Gorkom, supported by Chelberg, as well as the advice of Trans Union's legal counsel and the directors' "knowledge of the market history of the Company's stock."<sup>19</sup>

When Trans Union shareholders brought a class action suit against the directors, the directors elected to present a unified defense. The court held that "since all of the defendant directors, outside as well as inside, take a unified position, we are required to treat all of the directors as one as to whether they are entitled to the protection of the business judgment rule."<sup>20</sup> Pursuant to this collective approach, the court did not distinguish between Van Gorkom's orchestration of the transaction without the board's knowledge, Chelberg's complicity, and the board's failure to become adequately informed or to sufficiently deliberate once it learned of the proposal. Instead, because the directors presented a uniform defense for their actions, the court held that they should be treated as a unit for assessing liability.

In this particular case, the collective approach was adopted at the directors' request. Justice Moore, at least, appeared skeptical that a collective focus was appropriate. During the appeal, the Delaware Supreme Court requested a special hearing to determine whether there were "factual or legal reasons" to treat the directors differently.<sup>21</sup> In the hearing, Justice Moore and directors' common counsel engaged in the following colloquy:

“JUSTICE MOORE: Is there a distinction between Chelberg and Van Gorkom vis-à-vis the other defendants?

COUNSEL: No, sir.

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<sup>16</sup> 488 A.2d 858 (Del. 1985).

<sup>17</sup> It was reported, however, that the directors paid very little of this amount: their D&O insurance paid \$10 million, the policy limit, and the acquiror, Jay Pritzker, paid nearly all of the \$13.5 million balance. See Bayless Manning, *Reflections and Practical Tips on Life in the Boardroom After Van Gorkom*, 41 BUS. LAW. 1, 1 (1985).

<sup>18</sup> 488 A.2d at 868.

<sup>19</sup> *Id.* at 869.

<sup>20</sup> *Id.* at 889.

<sup>21</sup> *Id.* at 899.

JUSTICE MOORE: None whatsoever?  
COUNSEL: I think not.”<sup>22</sup>

According to Charles O’Kelley and Robert Thompson, the court was “trying to drive a wedge between directors who were negligent or disloyal and those who were not.”<sup>23</sup> The directors, however, chose the collective strategy in the hopes that the court would be unwilling to find the outside directors liable, thereby also shielding the more culpable insiders. The *Van Gorkom* court did honor the directors’ request for collective treatment, but instead of exonerating the directors, it “exploded a bomb”<sup>24</sup> by splitting 3-2 in favor of liability for the whole board – including a director who was ill and had not been present at the meeting where the sale was approved.<sup>25</sup> Justice Moore, one of the three judges voting in favor of liability, later stated that “the strategic maneuver to cast down the gauntlet before the Delaware Supreme Court hardly appears to have been among the wisest decisions in the annals of corporate America.”<sup>26</sup>

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<sup>22</sup> *Id.*

<sup>23</sup> CHARLES R.T. O’KELLEY AND ROBERT B. THOMPSON, CORPORATIONS AND OTHER BUSINESS ASSOCIATIONS (4<sup>TH</sup> ed. 2003), TEACHER’S MANUAL at 111. *See also* Jonathan R. Macey, *Symposium: Smith v. Van Gorkom: Insights About C.E.O.s, Corporate Law Rules, and the Jurisdictional Competition for Corporate Charters*, 96 NW U. L. REV. 607, 609-619 (2002) (arguing that in *Van Gorkom*, the whole board was punished for Jerome Van Gorkom’s misconduct). *Cf.* Elliott J. Weiss, *What Lawyers Do When the Emperor Has No Clothes: Evaluating CTS Corp. v. Dynamics Corp. of America and its Progeny—Part I*, 78 GEO. L. J. 1655, 1658 n. 18 (“In my view, the *Van Gorkom* court was concerned primarily with the manner in which Van Gorkom...presented the proposed transaction to the board, and with the outside directors’ refusal to dissociate themselves from Van Gorkom when they learned that he had provided them with incomplete information.”).

<sup>24</sup> Manning, *supra* note 17, at 1.

<sup>25</sup> Upon release of the court’s judgment of liability, this outside director, Thomas O’Boyle, was granted leave for a change of counsel. In his motion for reargument, O’Boyle claimed “standing to take a position different from that of his fellow directors and that legal grounds exist for finding him not liable for the acts or omissions of his fellow directors.” 488 A.2d at 898. The court unanimously ruled that this argument had been waived, noting that during trial “a special opportunity was afforded the individual defendants, including O’Boyle, to present any factual or legal reasons why each or any of them should be individually treated.” *Id.* at 899.

<sup>26</sup> Andrew G.T. Moore II, *The 1980s—Did We Save the Stockholders While the Corporation Burned?*, 70 WASH. U. L.Q. 277, 281-82 (1992):

This [collective] position was taken even though it was obvious that certain directors were more culpable than others, and in the face of the Court’s invitation that they take separate positions with a clear hint of exoneration for all but the most culpable insiders....In a way, they were ‘daring’ us to find them all liable to save certain insiders. In light of our decision finding all the directors liable, the strategic maneuver to cast down the gauntlet before the Delaware Supreme Court hardly appears to have been among the wisest decisions in the annals of corporate America.

## 2. *In re Emerging Communications, Inc. Shareholders Litigation*

After *Van Gorkom*, the Delaware courts did not explicitly revisit the individual/collective question until 2004, in the case of *In re: Emerging Communications, Inc. Shareholders Litigation*.<sup>27</sup> This class action suit alleged that the directors of Emerging Communications, Inc. breached their fiduciary duties in approving a “going private” acquisition of the company by its Chairman and CEO, Jeffrey Prosser.<sup>28</sup> The transaction was originally proposed to be a merger of another corporation owned by Prosser into Emerging Communications. Prosser, however, “flipped” the transaction to a privatization in which his other corporation would acquire Emerging Communications due to his belief that the market had undervalued Emerging Communications, making it available for purchase at a discounted price.<sup>29</sup>

The Emerging Communications board was comprised of seven directors, including inside director Prosser, inside director and company counsel John Raynor, and outside director and financial expert Salvatore Muoio. Justice Jacobs of the Delaware Supreme Court, sitting by designation on the Chancery Court, found these three directors, but none others, jointly and severally liable for breaching their fiduciary duties of loyalty “and/or” good faith in approving the privatization at \$10.25 per share given the judicially determined fair value of \$38.05 per share.<sup>30</sup>

In his opinion, without citing *Van Gorkom*, Justice Jacobs held that “[t]he liability of the directors must be determined on an individual basis because the nature of their breach of duty (if any), and whether they are exculpated from liability for that breach, can vary for each director.”<sup>31</sup> Applying this individual approach, Justice Jacobs imposed liability on Prosser for violating his duty of loyalty for self-dealing,<sup>32</sup> Raynor for breaching his duty of loyalty “and/or” good faith for assisting Prosser in the privatization and for “consciously disregarding his duty to the minority

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<sup>27</sup> 2004 WL 1305745.

<sup>28</sup> The privatization occurred in two steps. First, Innovative Communications Corporation, L.L.C., which was effectively wholly owned by Prosser and was already the majority stockholder of Emerging Communications, acquired 29% of Emerging Communications’ outstanding shares in a first-step tender offer. Two months later, Innovative acquired the balance of the outstanding shares in a second-step cash-out merger of Emerging Communications into an Innovative subsidiary. *Id.* at \*1.

<sup>29</sup> *Id.* at \*5.

<sup>30</sup> *Id.* at \*11.

<sup>31</sup> *Id.* at \*38.

<sup>32</sup> Prosser also breached his duty of loyalty as a majority stockholder of Emerging Communications “by eliminating [the company’s] minority stockholders for an unfair price in an unfair transaction that afforded the minority no procedural protections.” *Id.* at \*38.

stockholders;”<sup>33</sup> and Muoio for breaching his duty of loyalty “and/or” good faith because he was not independent of Prosser and “voted to approve the transaction even though he knew, or at the very least had strong reasons to believe, that the \$10.25 per share merger price was unfair” given his financial expertise.<sup>34</sup> The other four directors, although “not independent of Prosser,”<sup>35</sup> were exonerated because their conduct did not rise to the level of disloyalty or bad faith.<sup>36</sup>

### 3. *In re The Walt Disney Co. Derivative Litigation*

In 2005, Chancellor Chandler issued his opinion on the merits of *In re Walt Disney Co. Derivate Litigation*.<sup>37</sup> Disney shareholders brought a derivative suit against the corporation’s directors in connection with the hiring and termination of Michael Ovitz as Disney’s president, which resulted in a severance payout to Ovitz of approximately \$140 million for fifteen months work.<sup>38</sup> The Disney board consisted of seventeen directors, including Chairman and CEO Michael Eisner and compensation committee members Irwin Russell, Raymond Watson, Sidney Poitier, and Ignacio “Nacho” Lozano. Eisner was the facilitator of Ovitz’s hiring, and the compensation committee assumed primary responsibility for the Ovitz employment agreement.

In a lengthy opinion that criticized the directors’ conduct in many respects,<sup>39</sup> Chancellor Chandler nevertheless found no fiduciary duty breaches in connection with the Ovitz employment agreement (in this

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<sup>33</sup> *Id.* at \*39 & n. 184.

<sup>34</sup> *Id.* at \*39-40.

<sup>35</sup> *Id.* at \*41.

<sup>36</sup> *Id.*:

The conduct of these four directors differs from that of Raynor and Muoio, in that there is no evidence that any of those four affirmatively colluded with Prosser to effect the Privatization, or that they otherwise deliberately engaged in conduct disloyal to the minority stockholders’ interests. Nor have the plaintiffs shown that any of those directors knew or had reason to believe, that the merger price was unfair.

<sup>37</sup> 2005 Del. Ch. LEXIS 113. This case had been bouncing between the Delaware Chancery and Supreme Courts for several years. For prior opinions in this case, *see* [cites].

<sup>38</sup> *See* Sean J. Griffith, *Good Faith Business Judgment: A Theory of Rhetoric in Corporate Law Jurisprudence*, 55 DUKE L. J. 1, 17 & n. 48 (2005) (noting that “Ovitz was paid approximately \$140 million in stock, cash, and options,” but that this “measure is approximate due to the problem of valuing the equity and the options. \$140 million is the plaintiff’s measurement of the total cost and may be high”).

<sup>39</sup> The specific critiques are too numerous to list, but the gist was that Eisner acted as an imperial CEO who negotiated with Ovitz in secret, and that the compensation committee (and to a lesser extent the full board) was comprised of Eisner’s cronies who simply acceded to his wishes.

case, the duties of care and good faith were implicated<sup>40</sup>). Before analyzing the merits of fiduciary duty claims, Chancellor Chandler took note of the conflicting answers to the individual/collective question set forth in *Van Gorkom* and *Emerging Communications*:

In *Van Gorkom*, the Delaware Supreme Court analyzed the Trans Union board of directors as a whole in determining whether the protections of the business judgment rule applied. More recent cases understand that liability must be on a director-by-director basis. In *Emerging Communications*, Justice Jacobs wrote (while sitting as a Vice Chancellor) that the “liability of the directors must be determined on an individual basis because the nature of their breach of duty (if any), and whether they are exculpated from liability for that breach, can vary for each director.” *There is a not insignificant degree of tension between these two positions*, notwithstanding the procedural differences between the two cases.<sup>41</sup>

After noting the tension between the prior cases, Chancellor Chandler analyzed the conduct of the primary actors (Eisner and each of the compensation committee members) individually. He determined that although their actions did not meet the ideal in corporate practices, neither did they fall below well-established fiduciary duty standards. The actions of the remainder of the board were analyzed only briefly and collectively.<sup>42</sup> The full board was also exonerated.<sup>43</sup> When the Delaware Supreme Court affirmed the Chancellor’s decision in June 2006, it did not reach the substance of the individual/collective question, instead finding that plaintiffs’ were procedurally barred from alleging the Chancellor’s use of the individual approach for the primary actors as error.<sup>44</sup> The court

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<sup>40</sup> The traditional duty of loyalty claims had been dropped fairly early in the suit. *See* Griffith, *supra* note 38, at 18-19.

<sup>41</sup> 2005 Del. Ch. LEXIS 113, at \*154 (citations omitted) (emphasis added).

<sup>42</sup> The Chancellor’s opinion devotes over thirty pages to scrutinizing the role of Eisner and the compensation committee members in approving Ovitz’s employment agreement, *id.* at \*190-224, but only three pages to all of the other directors combined. *Id.* at \*225-228. This is because the board’s sole action was to approve Ovitz as president – the terms of his employment were delegated to the compensation committee. Plaintiffs alleged this delegation as error in their appeal to the Delaware Supreme Court, which was rejected. 2006 Del. LEXIS 307, at [cite] (“The Chancellor’s ruling – that executive compensation was to be fixed by the compensation committee – is legally correct.”).

<sup>43</sup> 2005 Del. Ch. LEXIS 113, at \*225-228.

<sup>44</sup> 2006 Del. LEXIS 307, \* 64:

To begin with, the argument is precluded by Rule 8 of this Court, which provides that arguments not fairly presented to the trial court will

added that the plaintiffs had not demonstrated prejudice from this approach.<sup>45</sup>

## B. Cases Implicitly Addressing the Individual/Collective Question

Although *Van Gorkom*, *Emerging Communications*, and *Disney* all explicitly addressed the individual/collective question, standing alone they do not tell us very much. *Emerging Communications* supports an individual focus for duty of loyalty claims, but it is only one case, and Justice Jacobs gave little reasoning for his individual focus. However, other case law is clear that consequences flow from even one director's disloyalty. For instance, corporate opportunity cases (a subset of the duty of loyalty) routinely center on allegations that a single director has usurped a corporate opportunity.<sup>46</sup> The consequences of disloyalty begin with greater judicial scrutiny of the challenged transaction, and potentially end with the imposition of liability on the disloyal director.<sup>47</sup> The relevant Delaware statutory provision, discussed below, is equally clear that an individual focus is required in duty of loyalty cases.<sup>48</sup> Although the good faith jurisprudence to this point has been quite confusing and in flux, *Emerging Communications* could be read to support an individual focus when good faith is implicated.<sup>49</sup>

*Van Gorkom* and *Disney* are less clear in their resolution of the individual/collective question in duty of care cases. In *Disney*, Chancellor Chandler cited *Van Gorkom* as adopting the collective focus, yet the *Van Gorkom* court chose the collective approach due to the directors' request rather than through any substantive reasoning. Similarly, it is difficult to know what to make of *Disney*, where carelessness allegations were interwoven with allegations of bad faith to propel plaintiffs past an early

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not be considered by this Court. The appellants' "individual vs. collective" argument goes beyond being not fairly presented. It borders on being unfairly presented, since the appellants are taking the trial court to task for adopting the very analytical approach that they themselves used in presenting their position.

(citation omitted).

<sup>45</sup> *See id.* ("The argument also fails because nowhere do appellants identify how this supposed error caused them any prejudice"). [Note: need to incorporate any post-*Disney* opinions mentioning the individual/collective question, including *Sample v. Morgan*, 2007 WL 177856 (Del. Ch.), into this section.]

<sup>46</sup> *See, e.g., Broz v. Cellular Information Systems, Inc.*, 673 A.2d 148 (Del. 1996).

<sup>47</sup> *See id.*

<sup>48</sup> *See infra* Part II.C.1.

<sup>49</sup> *See supra* Part II.A.2 (discussing Justice Jacobs' individual director focus for breaches of the duties of loyalty "and/or" good faith).

motion to dismiss.<sup>50</sup> The Delaware Supreme Court did not address the substance of the individual/collective question, while Chancellor Chandler took somewhat of a hybrid approach, analyzing Eisner and the compensation committee individually and the remainder of the board collectively. Looking to cases that have *implicitly* resolved this issue, however, supports *Van Gorkom's* collective focus in duty of care cases.

Courts generally do not draw distinctions among directors based on their inside/outside director status or expert/non-expert qualifications when assessing compliance with the duty of care,<sup>51</sup> which points toward a collective focus. First, even though “inside” and “outside” directors serve different functions,<sup>52</sup> with inside directors being more intimately involved in managing corporate affairs and outside directors playing more of a monitoring role,<sup>53</sup> courts generally do not hold inside directors to a higher

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<sup>50</sup> Duty of care claims, standing alone, are subject to dismissal if the corporation has adopted a 102(b)(7) provision. *See infra* notes 133-136 and accompanying text. *See also* Norman Veasey and Christine T. Di Guglielmo, *What Happened in Delaware Corporate Law and Governance from 1992-2004? A Retrospective on Some Key Developments*, 153 U. PA. L. REV. 1399, 1441 (2005) (“the Disney litigation – as the Supreme Court saw it in *Brehm v. Eisner* in 2000, based on the original and defective set of pleadings – seemed to be primarily a due care case....On remand, the case, as repleaded, morphed into a ‘good faith’ case.”).

<sup>51</sup> Courts do distinguish between inside and outside/independent directors for other purposes, however. *See infra* note 91.

<sup>52</sup> This article draws a basic distinction between inside directors, who are also officers/management of the corporation, and outside directors, who are not. *See* O’KELLEY AND THOMPSON, *supra* note 23, at 136 (inside directors are “generally the chief executive officer and her principal subordinate officers” while outside directors are “usually are employed full time as either chief executives or financial officers of other corporations, or are lawyers, accountants, or investment bankers”). Outside directors may or may not qualify as “independent” depending on the standard used. *See* Hillary A. Sale, *Independent Directors as Securities Monitors*, \_\_ BUS. LAW. \_\_, \_\_ n. 4 (2006) (to be independent under New York Stock Exchange (NYSE) rules, “directors must not have any significant familial or financial ties with the company,” while to be independent under Delaware law, “a director must not be beholden to her fellow board members and able to formulate her own decisions on issues free of improper influence”). For criticism of the more formalistic NYSE definition of independence, *see* Stephen M. Bainbridge, *A Critique of the NYSE’s Director Independence Listing Standards*, 30 SEC. REG. L. J. 370 (2002). For an alternative approach to independence, *see* Note, *Beyond “Independent” Directors: A Functional Approach to Board Independence*, 119 HARV. L. REV. 1553 (2006).

<sup>53</sup> *See* Ronald J. Gilson and Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STAN. L. REV. 863, 873 (1991):

The justification for relying on outside directors as a monitoring mechanism is straightforward. Because such directors are “independent” – that is, they do not have a personal financial stake in retaining management – they can act as shareholder surrogates to assure that the company is run in the long-term best interests of its owners.

standard of care. For example, in *Norlin v. Rooney*,<sup>54</sup> the Second Circuit stated that “[w]e are not persuaded that a different test applies to ‘independent’ as opposed to ‘inside’ directors under the business judgment rule.”<sup>55</sup> There are exceptions in the case law, however,<sup>56</sup> and outside directors are entitled to more reliance on reports made by corporate officers, accountants or appraisers in fulfilling their duty of care than are inside directors.<sup>57</sup>

Courts have also tended to hold expert and non-expert directors to the same standard of care. For example, in the 2006 case of *Canadian Commercial Workers Industry Pension Plan v. Alden*,<sup>58</sup> the Delaware Chancery Court held that “Plaintiff’s argument that Defendants should be held to a higher standard of care because they are professionals [an accountant and a lawyer] is unavailing.”<sup>59</sup> Norman Veasey, former Chief

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On monitoring vs. managing boards, see MELVIN A. EISENBERG, *THE STRUCTURE OF THE CORPORATION: A LEGAL ANALYSIS* (1997); Fisch, *supra* note 3.

<sup>54</sup> 744 F.2d 255 (2<sup>nd</sup> Cir. 1984).

<sup>55</sup> *Id.* at 260. See also Donald E. Pease, *Outside Directors: Their Importance to the Corporation and Protection from Liability*, 12 DEL. J. CORP. L. 25, 49 (1987):

In *Aronson v. Lewis*, the court said that the directors have a duty to inform themselves of all material information reasonably available before making a decision and that they must act with requisite care in the discharge of their duties. There is no hint in *Aronson* of a distinction between the responsibility of inside and outside directors; apparently they are all subject to the same standard.

(citations omitted); In re Caremark International Inc. Derivative Litigation, 698 A.2d 959 (1996). It should be noted, however, the Delaware Supreme Court has recently pronounced that so-called “duty to monitor” cases such as *Aronson* and *Caremark*, widely thought to be due care cases, are really good faith/loyalty cases. See *infra* Part III.B.1.b.

<sup>56</sup> For a case that is sometimes cited in support of lesser fiduciary duty standards for outside directors, see *Rowen v. Le Mars Mutual Ins. Co. of Iowa*, 282 N.W.2d 639, 652 (Iowa 1979) (subjecting outside directors to lesser fiduciary duty standards because “an outside director does not have the same duty or responsibility that falls upon those who are in active charge and who dictate day-to-day policy”).

<sup>57</sup> See Del. Code Ann. tit. 8 § 141(e):

A member of the board of directors, or a member of any committee designated by the board of directors, shall, in the performance of such member's duties, be fully protected in relying in good faith upon the records of the corporation and upon such information, opinions, reports or statements presented to the corporation by any of the corporation's officers or employees, or committees of the board of directors, or by any other person as to matters the member reasonably believes are within such other person's professional or expert competence and who has been selected with reasonable care by or on behalf of the corporation.

<sup>58</sup> 2006 Del. Ch. LEXIS 42.

<sup>59</sup> *Id.* at \*29, n. 54.

Justice of the Delaware Supreme Court, recently opined that “[i]t would be a perversity of corporate governance goals, in my view, for the Delaware courts to announce a general rule that a director with special expertise is more exposed to liability than other directors solely because of her status as an expert.”<sup>60</sup> Justice Jacobs’ more stringent treatment of financial expert Mouio in *Emerging Communications* appears to be an exception to this general rule,<sup>61</sup> although that opinion can be read to call into question Mouio’s good faith due to his expert status rather than alter his standard of care.<sup>62</sup> (If the latter reading is correct, it also supports an individual focus in good faith cases.) Whether there should be an expert/non-expert distinction has been the topic of recent discussion, particularly as it relates to audit committees.<sup>63</sup>

If courts wished to account for the differences among directors in assessing due care compliance, we would expect to them to draw distinctions based on inside/outside director status and expert/non-expert qualifications. The fact that courts are not routinely drawing these distinctions suggests that they deem a collective focus appropriate in duty of care cases.

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<sup>60</sup> Veasey and Di Guglielmo, *supra* note 50, at 1446.

<sup>61</sup> *See supra* note 34 and accompanying text.

<sup>62</sup> This is how Chief Justice Veasey appears to read *Emerging Communications*. In discussing Mouio’s liability, he states:

When purporting to rely on another expert in a transaction where a director knows that the expert’s opinion is questionable, the director could be at greater risk of liability than the other directors. This is not because of the director’s status as an expert. It is simply that a director with such expertise cannot rely in good faith on another expert’s particular opinions under section 141(e).

Veasey and Di Guglielmo, *supra* note 50, at 1446.

<sup>63</sup> The SEC has come out against a heightened standard of liability for financial experts on audit committees. *See* Exchange Act Release No. 47,235 [2002-2003 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 86,818, at 86,894 (Jan. 23, 2003) (“Our new rule provides that whether a person is, or is not, an audit committee financial expert does not alter his or her duties, obligations or liabilities...under federal or state law.”) For conflicting views on whether audit committee members should be held to a higher standard of care, *compare* Jill E. Fisch and Caroline M. Gentile, *The Qualified Legal Compliance Committee: Using the Attorney Conduct Rules to Restructure the Board of Directors*, 53 DUKE L.J. 517, 572 (2003) (asking “[i]f, as the Commission’s safe harbor suggests, audit committee members do not face increased liability exposure, is it realistic to expect them to play an active role?”) *with* Kevin Iurato, *Comment: Warning! A Position on the Audit Committee Could Mean Greater Exposure to Liability: The Problems with Applying a Heightened Standard of Care to the Corporate Audit Committee*, 30 STETSON L. REV. 977 (2001).

## C. Relevant Statutory Provisions

### 1. *Delaware General Corporation Law § 144*

Finally, two important statutory provisions on fiduciary duties add to our body of existing law addressing the individual/collective question. The first is Delaware General Corporation Law Section 144, which speaks to the duty of loyalty and holds that certain transactions are not void solely because of “1 or more” directors’ self-dealing.<sup>64</sup> The mechanisms that can save a self-dealing transaction from automatic voidability are: (1) disclosure of the conflict followed by the approval of disinterested directors; (2) disclosure of the conflict followed by the approval of shareholders; or (3) a judicial determination that the transaction was fair to the corporation.<sup>65</sup> If the transaction cannot be saved through these mechanisms, the self-dealing director owes damages in an amount equal to the “unfairness” of the transaction, a measure usually based on rescission or restitution.<sup>66</sup>

Section 144’s use of the language “1 or more” to modify directors makes clear that even one director’s self-dealing forms the basis for greater judicial scrutiny of the transaction, and potentially for liability. Consequently, it supports the case law’s preference for an individual director focus in duty of loyalty cases.

### 2. *Model Business Corporation Act § 8.30*

Although this article focuses on Delaware law, the Model Business Corporation Act (MBCA) has been enacted in some form by a majority of states and therefore constitutes an important source of corporate law.<sup>67</sup>

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<sup>64</sup> *Del. Code Ann. tit. 8 § 144(a)*.

<sup>65</sup> See ROBERT CLARK, *CORPORATE LAW*, 167-70 (1986) (discussing these mechanisms but noting that disclosure plus either disinterested director approval or shareholder approval does not mean that a court cannot also inquire into entire fairness). In the past, interested director transactions were automatically voidable by the corporation regardless of whether they had been disclosed, approved, or were fair to the corporation. See Harold Marsh, *Are Directors Trustees? Conflict of Interest and Corporate Morality*, 22 *BUS. LAW.* 35, 35 (1966).

<sup>66</sup> CLARK, *supra* note 65, at 175 (“For example, when an officer sells property at an unfair, inflated price to his corporation, he becomes liable for the difference between the actual price and the fair value of the property.”); Melvin A. Eisenberg, *Corporate Law and Social Norms*, 99 *COLUM. L. REV.* 1253, 1276 (1999) (“Generally speaking, the legal sanctions for violating the duty of loyalty are inefficiently low. The primary legal sanctions are rescission and restitution.”). See also *Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1134, 1147-1150 (Del. Ch. 1994), *aff’d*, 663 A.2d 1156 (Del. 1995); *Weinberger v. UOP, Inc.*, 457 A.2d 701, 714 (Del. 1983).

<sup>67</sup> See Veasey and Di Guglielmo, *supra* note 50, at 1417 (“Although Delaware is not a Model Act state, it is sometimes helpful to learn from the articulation of the

After its 1998 revision, the MBCA was clear in its preference for a collective focus on the directors in duty of care cases.<sup>68</sup> MBCA Section 8.30 speaks to the duty of care as a standard of conduct.<sup>69</sup> The official comment to that section reads “[w]hile certain aspects [of a director’s performance] will involve individual conduct (e.g., preparation for meetings), these functions are generally performed by the board through collegial action.”<sup>70</sup> Gordon Smith remarks that the revisions “took further pains to subordinate the concept of care, placing it in a separate provision whose wording was intended to suggest that care primarily is a concern of the board as a separate institution, not the individual director.”<sup>71</sup> Jeffrey Bauman, Elliott Weiss, and Alan Palmiter also note the MBCA’s sharp focus on the whole board:

A significant change in the amended MBCA § 8.30... is the emphasis on the board as a collective decision-making body....The Official Comment to MBCA § 8.30...emphasizes that in evaluating board actions, it will be the conduct of the entire board rather than a particular director that will be most important.<sup>72</sup>

In sum, while *Van Gorkom* and *Disney* do not say much about how courts view the individual/collective question in duty of care cases, the case law that implicitly addresses the question suggests a preference for a collective focus. In addition, although there is no statutory provision

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corporate law in the MBCA. The MBCA is followed in varying forms by a majority of the states....”).

<sup>68</sup> For a discussion of the 1998 revisions, see R. Franklin Balotti and Joseph Hinsey IV, *Director Care, Conduct, and Liability: The Model Business Corporation Act Solution*, 56 BUS. LAW. 35 (2000).

<sup>69</sup> MODEL BUS. CORP. ACT (MBCA) § 8.30(b):

The members of the board of directors or a committee of the board, when becoming informed in connection with their decision-making function or devoting attention to their oversight function, shall discharge their duties with the care that a person in a like position would reasonably believe appropriate under similar circumstances.

The standard of liability is found in § 8.31. For the difference between standards of conduct and standards of liability, see *infra* notes 173-181 and accompanying text.

<sup>70</sup> § 8.30(b) cmt.

<sup>71</sup> D. Gordon Smith, *A Proposal to Eliminate Director Standards from the Model Business Corporation Act*, 67 U. CIN. L. REV. 1201, 1213 (1999).

<sup>72</sup> JEFFREY D. BAUMAN ET AL., *CORPORATIONS LAW AND POLICY: MATERIAL AND PROBLEMS* 673 (5<sup>th</sup> ed. 2003).

similar to MBCA § 8.30 in Delaware,<sup>73</sup> the MBCA provision further reveals a preference for a collective focus in duty of care cases.

### III

#### ANSWERING THE INDIVIDUAL/COLLECTIVE QUESTION ON CORPORATE GOVERNANCE POLICY GROUNDS

The previous Part observed that courts have answered the question of individual or collective liability for directors differently depending on the type of fiduciary duty at issue. This Part asks whether this duty-based approach – which treats loyalty breaches individually and due care breaches collectively – can be defended on corporate governance policy grounds. More specifically, it asks whether this duty-based approach will improve board functioning. Because the courts’ approach strikes the right balance between a board’s authority and accountability, and because it furthers the deterrence and compensation goals underlying fiduciary duty suits, this Part concludes that a duty-based approach is normatively desirable.

#### A. Normative Criteria for Promoting a Well-Functioning Board

##### 1. *Board’s Authority/Accountability Balance*

Drawing on the work of Nobel laureate economist Kenneth Arrow,<sup>74</sup> Stephen Bainbridge has stated that the balance between a board’s authority and its accountability is what “all of corporate law” is intended to achieve.<sup>75</sup> On the one hand, the board has almost complete authority over corporate affairs pursuant to the laws of Delaware and every other state.<sup>76</sup> In theory, shareholders retain some control rights – most notably the right to elect directors, amend corporate bylaws, and approve certain major transactions – but even these rights are severely limited in practice.<sup>77</sup> The

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<sup>73</sup> See Smith, *supra* note 71, at 1227 (“It is worth remembering that Delaware does not have a statutory provision prescribing the duty of care.”).

<sup>74</sup> KENNETH J. ARROW, *THE LIMITS OF ORGANIZATION* (1974).

<sup>75</sup> Stephen M. Bainbridge, *The Business Judgment Rule as Abstention Doctrine*, 57 VAND. L. REV. 83, 84 (2004) (“My analysis is grounded on the core proposition that the business judgment rule, like all of corporate law, is designed to effect a compromise – on a case-by-case basis – between two competing values: authority and accountability. These values refer, respectively, to the need to preserve the board of directors’ decision-making discretion and the need to hold the board accountable for its decisions.”) (citation omitted). For an earlier discussion of Arrow’s work, see D. Gordon Smith, *Corporate Governance and Managerial Incompetence: Lessons from Kmart*, 74 N.C. L. REV. 1037, 1119 (1996).

<sup>76</sup> *Del. Code Ann. tit. 8 § 141*.

<sup>77</sup> For instance, although shareholders have the right to elect directors, they must choose from management’s nominees or instigate a proxy fight. Similarly, although

board's wide authority is acknowledged to be "essential for organizational efficiency" given the separation of ownership and control in public corporations.<sup>78</sup> On the other hand, the board must exercise its authority responsibly, as directors who serve their own interests rather than the interests of shareholders do not increase shareholder wealth. Fiduciary duties are one way of holding directors accountable to shareholders, thereby reducing agency costs.<sup>79</sup> Accountability, whether imposed through fiduciary duty law or some other means, serves as the competing principle to authority, and "one cannot have more of one without also having less of the other."<sup>80</sup> The pertinent question, then, is where do we draw the line between authority and accountability to achieve optimal balance?<sup>81</sup>

In fiduciary duty litigation, the answer may seem simple: hold directors accountable only if they breach their fiduciary duties, otherwise respect their authority. But the matter is more complicated when the individual/collective question presents itself – i.e., when some directors breach and others do not. Employing an individual focus and holding only the breachers liable does not produce optimal results in all cases. Instead, the choice between an individual or collective focus should be informed by the adequacy of the board's decisionmaking *process*.<sup>82</sup> The goal, after

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shareholders have the right to approve certain major transactions, such as the sale of the corporation, any such action must first be instigated by the board. See Bainbridge, *supra* note 2, at 568-573. Given this reality, some corporate law scholars argue in favor of increased power for shareholders. See Lucian Ayre Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833 (2005); LUCIAN BEBCHUK AND JESSE FRIED, PAY WITHOUT PERFORMANCE 201-16 (2004); Robert B. Thompson and D. Gordon Smith, *Toward a New Theory of the Shareholder Role: "Sacred Space" in Corporate Takeovers*, 80 TEX. L. REV. 261 (2001).

<sup>78</sup> Bainbridge, *supra* note 75, at 107.

<sup>79</sup> Although directors are not technically agents and shareholders are not technically principals, the agency theory of the firm has "dominated corporate legal scholarship for at least two decades." Thompson and Smith, *supra* note 77, at 268. For the argument that the corporate law literature has overemphasized the importance of agency costs, see Robert K. Rasmussen and Douglas G. Baird, *The Prime Directive*, draft available at [http://papers.ssrn.com/sol3/Papers.cfm?abstract\\_id=930187](http://papers.ssrn.com/sol3/Papers.cfm?abstract_id=930187).

<sup>80</sup> *Id.* at 103.

<sup>81</sup> This question was the subject of an online debate between Gordon Smith and Stephen Bainbridge in September 2006, although that debate was concerned with increased shareholder participation in corporate governance rather than fiduciary duty litigation. See <http://www.pointoflaw.com/feature/> (last visited September 23, 2006).

<sup>82</sup> Corporate law tends to focus on the board's decisionmaking process rather than the substantive decision that results from that process. Consider corporate law's most ubiquitous tenet, the business judgment rule. Under the business judgment rule, if a board deliberates in an informed manner and acts in the best interests of the corporation, then a negative substantive outcome will not result in director liability. See *In re Caremark International, Inc. Derivative Litigation*, 698 A.2d 959, 968 (1996) ("[t]he business judgment rule is process oriented"); Melvin Aron Eisenberg, *Symposium: The Director's Duty of Care in Negotiated Dispositions*, 51 U. MIAMI L. REV. 579, 590

all, is to promote a well-functioning board that will make wealth-enhancing decisions. If a single director's breach jeopardizes that goal, is it not appropriate to account for that? Similarly, if a single director's breach does not jeopardize that goal, is it not appropriate to take that into consideration as well?

Accordingly, the authority/accountability line should be drawn between board processes that are likely to be adequate – i.e., where we have reasonable confidence that a fiduciary duty breach did not effect the board's outcome – and those that are not. If the board's process is likely to be adequate, we should respect the board's authority through judicial restraint. But if the board's process is likely to be inadequate, we should favor director accountability through judicial intervention. It is critical to draw the line in the proper place. Favoring accountability too often would diminish the efficiency benefits of centralized decisionmaking. Too much intrusion into the board's process and too high an incidence of director liability can chill director risk-taking and dissuade outside directors from serving on boards.<sup>83</sup> However, favoring authority too often would give directors little incentive to engage in good decisionmaking.<sup>84</sup> Some threat of intrusion and the imposition of director liability can serve to induce better fiduciary duty behavior, and also award compensation to aggrieved shareholders when warranted.<sup>85</sup> Striking the right balance between authority and accountability in fiduciary duty litigation is essential to ensuring a well-functioning board,<sup>86</sup> and the individual/collective question speaks directly to that balance.

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(1997) (“The sharp differentiation between the standards of review of the quality of board decisions on the one hand, and the decisionmaking process on the other, may be seen as a special case of a recurrent legal tendency to review procedure much more intensively than substance.”).

<sup>83</sup> This is commonly thought to be the effect of *Van Gorkom*, and why the Delaware legislature responded by eviscerating the duty of care in its aftermath. See Roberta Romano, *What Went Wrong With Directors' and Officers' Liability Insurance*, 14 DEL. J. CORP. L. 1 (1989). See also Bernard Black et al., *Outside Director Liability*, 58 STAN. L. REV. 1059 (2006) (“Regardless of one's position on the [desirability of outside director liability]...all would agree that, beyond some level of liability risk, qualified people may decide not to serve as directors and that those who do serve may become excessively cautious. Too much fear of liability, therefore, may reduce rather than enhance the quality of board decisions.”).

<sup>84</sup> This assumes that non-legal sanctions alone cannot adequately police director misbehavior, a claim that some academics would dispute. See *supra* note 8.

<sup>85</sup> See, e.g., Fairfax, *supra* note 6, at 395 (“legal liability represents an essential mechanism for ensuring directors' fidelity to their fiduciary duties”).

<sup>86</sup> See Lyman Johnson, *After Enron: Remembering Loyalty Discourse in Corporate Law*, 28 DEL. J. CORP. L. 27, 27 (2003):

In a post-Enron world of corporate governance scandal and calls for reform, fiduciary duty law presents, as a policy matter, a possible state law-based approach for attaining greater director accountability. The wisdom of doing so will depend, in part, on whether the risk of greater

Of the two approaches, the individual approach favors accountability over authority by allowing greater judicial intrusion into the boardroom. It allows courts to rebut the presumptions of the business judgment rule and engage in more extensive review of a board's process, possibly imposing director liability, based on a fiduciary duty breach by even one director. Because it shifts authority from boards to judges, the individual approach should be reserved for cases where a sole director's fiduciary duty breach is harmful enough to meaningfully taint the board's process and shake our confidence in the resulting outcome. In other words, an individual focus is appropriate where a sole director's actions are sufficiently grave to jeopardize the functioning of the whole board. In practice, the breaching director is the only director who faces liability.

The collective approach, on the other hand, favors authority over accountability by deferring to the board's process. It only allows for judicial intervention and director liability in cases where a significant number of directors have breached their fiduciary duties. Because it allows a single director's fiduciary breach to go unaccounted for, the collective approach should be reserved for cases where that breach is not harmful enough to meaningfully taint the board's process and shake our confidence in the resulting outcome. In other words, a collective focus is appropriate where the board functions adequately despite the wrongdoing or lapse of an individual director.

Courts could, of course, use the collective approach to impose liability on the full board for the wrongdoing of even a single director, thereby enticing outside directors to more carefully monitor inside directors.<sup>87</sup> Daryl Levinson has argued that collective sanctions of this kind "make functional sense when group members have the capacity to monitor and control the behavior of some intuitively primary wrongdoer more efficiently than an external sanctioner."<sup>88</sup> Levinson notes that

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financial exposure will induce enhanced discharge of director responsibilities, to the advantage of shareholders, or dissuade capable prospective director candidates from service, to the detriment of shareholders.

<sup>87</sup> The use of outside directors as monitors firmly established as corporate governance policy. In the wake of recent corporate scandals, the perceived importance of outside directors has received even more attention than in the past. See James D. Cox, *Symposium: Lessons from Enron, How Did Corporate and Securities Law Fail? Managing and Monitoring Conflicts of Interest: Empowering the Outside Directors with Independent Counsel*, 48 VILL. L. REV. 1077, 1078 (2003) ("It is safe to say that expectations for the independent director have never been higher than they are today."); Fisch, *supra* note 3 (discussing managerial vs. monitoring boards); Sale, *supra* note 52 (SEC now envisions a heightened role for independent directors as securities monitors). See also *supra* note 53 (rationale behind using outside directors as monitors).

<sup>88</sup> Daryl J. Levinson, *Collective Sanctions*, 56 STAN. L. REV. 345, 426 (2003). See also Note, *Collective Sanctions and Large Law Firm Discipline*, 118 HARV. L. REV. 2336 (2005); CHRISTOPHER KUTZ, *COMPLICITY* 162 (2000) ("I suggest that those who contribute to collective acts on an ongoing basis will fall into the category of intentional participants so long as they see themselves as part of a collective act, and whether or not

vicarious liability and joint and several liability are based on the idea of collective sanctions.<sup>89</sup> Although collective sanctions are an interesting theoretical possibility in fiduciary duty litigation, they have not been widely used. Courts do not typically impose fiduciary liability on a full board for an individual director's breach.

In a recent empirical study, Bernard Black, Brian Cheffins, and Michael Klausner found only three cases in the past 25 years, including *Van Gorkom*, where outside directors made out-of-pocket payments for fiduciary duty breaches.<sup>90</sup> This low incidence of outside director liability is partially because, *Van Gorkom* notwithstanding, less-culpable outside directors do tend to shield more-culpable inside directors from liability.<sup>91</sup> Under the collective approach, non-breaching directors tend to protect breaching directors rather than vice versa. Therefore, a collective focus is not used to impose accountability through collective sanctions, but instead to reinforce the board's authority.

## 2. *The Deterrence and Compensation Goals Underlying Fiduciary Duty Suits*

If achieving the proper balance between a board's authority and its accountability is the ideal in corporate governance, then it should have the most to say about our answer to the individual/collective question. However, fiduciary duty litigation is a particular subset of corporate

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they favor the collective goal. If so, they are subject to the inclusive ascription of collective acts.”).

<sup>89</sup> Levinson, *supra* note 88, at 362-370.

<sup>90</sup> See Black et al., *supra* note 83, at 1055 (empirical study finding that outside directors of public companies have made personal payments in only thirteen cases in the last twenty-five years, and only three of these thirteen case involved state law fiduciary duties). The authors did not count *Emerging Communications*, which, if outside director Muoio ended up making an out-of-pocket payment, would make the fourth case.

<sup>91</sup> Outside/independent directors provide other legal benefits as well. A board's decision not to pursue a derivative action after demand, or a special litigation committee's decision to dismiss a suit after demand futility, is more likely to be protected by the business judgment rule if directors are disinterested and independent. See *Aronson v. Lewis*, 473 A.2d 805 (Del. 1984) (on demand futility); *Zapata Corp. v. Maldonado*, 430 A.2d 779 (Del. 1981) (on special litigation committees). Also, “the Delaware courts have held that the decisions of boards with a majority of outside directors are entitled to certain beneficial presumptions.” Pease, *supra* note 55, at 35 (citing *Puma v. Marriott*, 283 A.2d 693 (1971), and takeover cases from the 1980s); see also *Ivanhoe v. Newport Mining Co.*, 535 A.2d 1334, 1343 (Del. 1987) (“with the independent directors in the majority, proof that the board acted in good faith and upon reasonable investigation is materially enhanced”); Laura Lin, *The Effectiveness of Outside Directors as a Corporate Governance Mechanism: Theories and Evidence*, 90 NW. U. L. REV. 898, 963 (1996) (“courts may be more inclined to approve the board's actions if the board was composed of a majority of independent outside directors”); see also Jeffrey N. Gordon, *Independent Directors and Stock Market Prices: The New Corporate Governance Paradigm*, draft available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=928100](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=928100).

governance, and the American Law Institute (ALI) identifies two specific goals for this litigation that must also be examined. First, fiduciary duty litigation is intended to deter against fiduciary duty breaches *ex ante*; second, it is intended to compensate for the losses those breaches cause *ex post*.<sup>92</sup> While these goals have been delineated separately from the authority/accountability balance, the following discussion shows that they ultimately inform that balance rather than compete with it.

#### a. Deterrence

The deterrence of director wrongdoing is thought to be a stronger rationale for allowing fiduciary duty suits than compensation.<sup>93</sup> The U.S. Supreme Court has remarked that even in cases where it “may be impossible to assign monetary value to the benefit,” fiduciary duty litigation can “render a substantial service to the corporation and its shareholders.”<sup>94</sup> It may be that fiduciary duty litigation itself is a weak

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<sup>92</sup> ALI PRINCIPLES OF CORPORATE GOVERNANCE, Introduction, Part VII, Reporter’s Note 2 (1992) [hereinafter ALI PRINCIPLES] (“As with other forms of tort actions, the derivative’s action’s principal goals are deterrence and compensation.”). Although the ALI Principles discuss fiduciary litigation that takes the form of a derivative suit, these suits have now taken a backseat to shareholder class actions. See Robert B. Thompson and Randall S. Thomas, *The Public and Private Face of Derivative Lawsuits*, 57 VAND. L. REV. 1747, 1762 (2004) (in Delaware in 1999 and 2000, 824 fiduciary duty suits were in the form of class actions, while only 137 were derivative suits). This is probably due to the derivative suit’s demand requirement and the mergers and acquisitions context in which these suits frequently arise, where shareholders can claim a direct injury. *Id.* at 1762. But the difference between derivative suits and class actions is of little consequence to the discussion at hand – the goals underlying derivative suits apply more or less equally to class actions. See ALI PRINCIPLES, *supra*, at 13 (deterrence rationale for derivative suits “applies as well to the context of shareholder litigation”).

<sup>93</sup> See ALI PRINCIPLES, *supra* note 92, Reporter’s Note at 16 (“if meritorious derivative actions seeking to enforce legal rules that protect all shareholders could be easily terminated simply by showing that they would not yield a positive net recovery, average agency costs might rise...”); James D. Cox, *American Law Institute’s Corporate Governance Project: Remedies: Compensation, Deterrence, and the Market as Boundaries for Derivative Suit Procedures*, 52 GEO. WASH. L. REV. 745 (1984):

In two important areas, the proposal to the ALI makes deterrence paramount over a compensatory objective. First, although defendants can usually avoid liability by establishing that their misconduct created a net benefit to the corporation, the proposal disallows such a defense if the court believes the defense ‘would frustrate an authoritatively established public policy.’ Second, courts in their review of a dismissal recommendation of a special litigation committee must find that ‘dismissal of the action would not frustrate any authoritatively established public policy.’

*But see* Bangor Punta Operations, Inc. v. Bangor & Aroostook R.R. Co., 417 U.S. 703 (1974).

<sup>94</sup> Mills v. Electric Auto-Lite Co., 396 U.S. 375, 396 (1970).

deterrent compared with market and other non-legal forces acting on directors.<sup>95</sup> The deterrent effect of fiduciary duty suits is certainly reduced by the availability of indemnification and D&O insurance, which serve to protect certain breaching directors from making personal payments.<sup>96</sup> Nevertheless, the threat of fiduciary liability is thought to play some role in deterring director wrongdoing, thereby reducing agency costs between shareholders and directors.<sup>97</sup> Consequently, some courts have allowed these suits to proceed even when damages are unavailable.<sup>98</sup>

The individual and collective approaches vary in their deterrent effect. The individual approach aims deterrence at each director on the board and penalizes even a single director's transgression. Consequently, the individual approach provides a harsh form of deterrence. It should therefore be reserved for cases where it is necessary for *every* director to act, or avoid acting, in a particular manner to ensure a reliable

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<sup>95</sup> See ALI PRINCIPLES, *supra* note 92, Introductory Note at 5 (“the derivative action is neither the initial nor the primary protection for shareholders against managerial misconduct. A variety of social and market forces also operate to hold corporate officials accountable”).

<sup>96</sup> Indemnification is available provided the directors have acted in good faith and in the best interests of the corporation. *Del. Code Ann. tit. 8 § 145* (limited permissive indemnification to amounts paid by a director “if such person acted in good faith and in a manner such person reasonably believed to be in or not opposed to the best interests of the corporation”). See also Karl E. Strauss, *Indemnification in Delaware: Balancing Policy Goals and Liabilities*, 29 DEL. J. CORP. L. 143 (2004). D&O insurance, which almost all public corporations have, provides a further backstop against personal liability. Because there are no limits imposed by corporate or securities laws on the scope of coverage, see Black et al., *supra* note 83, at 1085, D&O insurance should be able to fill any holes left by good faith exclusions in indemnification. *Id.* at 1094 (“even outside directors whose oversight failure is so extreme as to meet the good faith standard may still be covered by D&O insurance to the extent of the policy limit...D&O policies exclude from coverage conduct that constitutes deliberate fraud or the taking of illegal profits. These exclusions are narrower than the conscious disregard of duty conception of good faith”).

<sup>97</sup> See, e.g., Robert C. Clark, *Agency Costs Versus Fiduciary Duties*, in PRINCIPALS AND AGENTS: THE STRUCTURE OF BUSINESS 55 (1985) (fiduciary duties can reduce agency costs); Robert H. Sitkoff, *An Agency Costs Theory of Trust Law*, 89 CORNELL L. REV. 621, 638 (2004) (“liability rules such as fiduciary duties...[are] devices for minimizing agency costs”).

<sup>98</sup> See *Diamond v. Oreamuno*, 248 NE 2d 910, 912 (NY 1969):

It is true that the complaint before us does not contain any allegation of damages to the corporation but this never has been considered to be an essential requirement for a cause of action founded on breach of fiduciary duty....This is because the function of such an action, unlike an ordinary tort or contract case, is not merely to compensate the plaintiffs for wrongs committed by the defendant but...‘to prevent them, by removing from agents and trustees all inducement to attempt dealing for their own benefit in matters which they have undertaken for others, or to which their agency or trust relates.’

(citation omitted).

decisionmaking process. Of course, it is always *desirable* for each director to comply with her fiduciary duties, but a balance must be maintained between properly deterring and overdetering to the point where directors do not take risks or want to serve on boards.<sup>99</sup> Again the goal of corporate law generally, and of the choice of assessment approach specifically, is to maintain the balance between a board's authority and its accountability. By favoring accountability, the individual approach may provide optimal deterrence in some cases but not in others.

The collective approach, on the other hand, aims deterrence at the board as a whole. If courts used this approach as a collective sanction – to penalize the whole board for the acts of individual directors – it could serve as a harsh form of deterrence aimed at outside directors who fail to monitor inside directors. As noted earlier, however, the collective approach does not operate as a collective sanction.<sup>100</sup> Instead, by requiring multiple breaches for judicial intervention, the collective approach is a weak form of deterrence that is appropriate where we worry about overdeterrence, and where we have confidence in the board's decisionmaking process if most directors comply with their fiduciary duties. The collective approach strikes the authority/accountability balance in favor of a board's authority, assuming less of a need for accountability.

## b. Compensation

The other goal of fiduciary duty suits – compensation – functions as a less-important rationale than deterrence if we accept the conventional wisdom that holding directors to account provides minimal economic benefits to shareholders, with plaintiff's attorneys being the primary economic beneficiaries.<sup>101</sup> Whether or not the conventional wisdom is

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<sup>99</sup> ALI PRINCIPLES, *supra* note 92, Introductory Note at 8 (the ALI seeks “to steer a middle course between excessive reliance on litigation remedies and the abolition of any judicial recourse for the shareholder,” and “is particularly sensitive to the danger of overdeterrence and the impact of even the potential risk of litigation on the willingness of outside directors to serve and on their conduct as directors”). *See also supra* note 83 and accompanying text.

<sup>100</sup> *See supra* notes 87-91 and accompanying text.

<sup>101</sup> For a critique of the plaintiff's attorney's role in shareholder litigation, *see* Reinier Kraakman et al., *When Are Shareholder Suits in Shareholder Interests?*, 82 GEO. L. J. 1733, 1734 n. 5 (1994) (collecting sources). *But see* Thompson and Thomas, *supra* note 92, at 1749-50 (“roughly 30 percent of the derivative suits provide relief to the corporation or the shareholders, while the others are usually dismissed quickly with little apparent litigation activity. In cases producing a recovery to shareholders, the amount of recovery typically exceeds the amount of attorneys' fees awarded by a significant margin”); Thomas M. Jones, *An Empirical Examination of the Resolution of Shareholder Derivative and Class Action Lawsuits*, 60 B.U. L. REV. 542 (1980) (plaintiff shareholders obtained recovery in approximately 75% of cases, but whether recovery exceeded costs of litigation was not measured). Shareholders prefer class actions to derivative suits as a means of compensation, as any sums recovered derivatively go back to the corporate

correct, the choice between an individual and collective focus impacts the likelihood of compensation. The individual director approach provides the most robust means of compensation, as even a single director's fiduciary duty breach can trigger a recovery. The recovery is not diminished because it comes from a single director, as breaching directors are jointly and severally liable for a plaintiff's entire loss.<sup>102</sup> The collective approach, on the other hand, makes compensation less likely by requiring a greater number of breaching directors to trigger recovery. As with deterrence, a court's choice between the two approaches should seek to appropriately compensate without overcompensating. To achieve this balance, courts should select the individual approach and award compensation in cases where a single director's breach is likely to be the proximate cause of a loss, but select the collective approach and deny compensation in cases where a single director's breach is unlikely to have led to the loss.<sup>103</sup>

## B. Application of Normative Criteria to Fiduciary Duty Claims

### 1. *Duty of Loyalty*

#### a. Self-Dealing

Applying these normative criteria to the different types of fiduciary duty claims that may be brought reveals support for the courts' answer to the individual/collective question based on fiduciary duty type. In choosing between the individual and collective approaches, classic duty of loyalty claims present the most straightforward analysis. As a general

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coffers, with shareholders compensated only indirectly through a *pro rata* increase in the value of their shares. See Thompson and Thomas, *supra* note 92, at 1758.

<sup>102</sup> See Van Gorkom, 488 A.2d 858 (imposing joint and several liability on all Trans Union directors); In re Emerging Communications, 2004 WL 1305745, at \*43 ("In the fiduciary duty action, defendants...are jointly and severally liable the plaintiff class..."); Trieweiler v. Sears, 689 NW2d 807, 835 (Neb. 2004) (based on the principle that co-agents are jointly and severally liable, "it has been held that directors and officers of a corporation are jointly and severally liable if they jointly participate in a breach of fiduciary duty"); Resolution Trust Corp. v. Block, 924 SW2d 354, 355 (Tenn 1996) ("While officers and directors' liability to the corporation has been attributed to various legal theories, it has been unanimously recognized that officer and director liability to the corporation for their collective actions is joint and several.") (citation omitted).

<sup>103</sup> Technically, only the board can cause a loss because no single director has the power to take action on behalf of the corporation. See RESTATEMENT (SECOND) OF AGENCY § 14C cmt. b ("An individual director...has no power of his own to act on the corporation's behalf, but only as one of the body of directors acting as a board."). However, the duty-of-loyalty rules essentially circumvent the board's role in the case of an undisclosed conflict-of-interest. If a single director has an undisclosed conflict, the only question is fairness. If a transaction is unfair, then only the single director is liable. This suggests that the single director is viewed as the proximate cause of the loss in such cases.

matter, a director breaches his duty of loyalty when he approves a corporate action that benefits himself at the shareholders' expense (so-called "self-dealing" transactions). For purposes of answering the individual/collective question, there are three things to note about self-dealing. First, it is intentional rather than negligent conduct. Second, it is typically done by inside directors, who may try to use their management positions and more intimate knowledge about the corporation to gain a personal benefit. Third, according to conventional wisdom, at least, these inside directors are likely to enjoy board capture, meaning that outside directors are likely to rubberstamp any recommendations the insiders make.<sup>104</sup> When these three things are combined, it is clear that self-dealing has the potential to taint the board's decisionmaking process in a meaningful way – toward the self-dealing director's ends and away from the shareholders' ends.<sup>105</sup> Therefore, it is appropriate to favor accountability over authority in these situations to ensure a functional board. An individual approach allows courts to engage in more extensive review of the board's process or the transaction's substantive merits, and to impose liability on disloyal directors in unfair transactions.

CEO Prosser's conduct in *Emerging Communications* provides a good illustration of why an individual focus is appropriate in self-dealing cases.<sup>106</sup> Prosser engaged in self-dealing by scrapping a merger and instead pushing a privatization, a transaction from which he "derived an improper personal benefit."<sup>107</sup> Because he would reap a personal financial benefit from the privatization, Prosser had motive to induce the board to vote his way without adequate consideration of the shareholders'

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<sup>104</sup> See CLARK, *supra* note 65, at 183 (detailing reasons why other directors might be beholden to the CEO); Bainbridge, *supra* note 75, at 105 ("In practice, of course, many boards of directors are captured by the firm's senior management and simply rubberstamp managerial decisions."); *In re: Walt Disney Co. Derivative Litigation*, 2005 Del. Ch. LEXIS 113, at \*191 ("Eisner stacked his (and I intentionally write 'his' as opposed to 'the Company's') board of directors with friends and other acquaintances who, though no necessarily beholden to him in a legal sense, were certainly more willing to accede to his wishes and support him unconditionally"). Post-Sarbanes-Oxley, however, this tendency to rubberstamp may be lessening. See "Why Corporate Boardrooms Are in Turmoil," *Wall St. J.*, September 16, 2006, p. A7 ("Corporate boards, which once served largely as rubber stamps for powerful CEOs, have become more independent, more powerful, and under more pressure to dump leaders who perform poorly.").

<sup>105</sup> See Jennifer M. Johnson and Mary Siegel, *Corporate Mergers: Redefining the Role of Target Directors*, 136 U. PA. L. REV. 315, 378 (1987) ("In merger approval cases, the directors' unavoidable conflict of interest may taint their actions and recommendations, thus undermining the effective operation of the structural and market monitors."); Karl F. Balz, *No-Shop Clauses*, 28 DEL. J. CORP. 513, 559-61 (2003) (discussing the harmful taint of disloyalty on the part of target company directors).

<sup>106</sup> See *supra* Part II.A.2.

<sup>107</sup> 2004 WL 1305745, at \*39.

interests. Because he was an inside director who enjoyed board capture,<sup>108</sup> the board went along with his proposal. The Emerging Communications board did not function properly because a single director was disloyal.

Deterrence and compensation are also properly aimed at individual directors in self-dealing cases. Recall that by penalizing even a single director's fiduciary duty breach, the individual approach provides a stricter form of deterrence and a more likely means of compensation than does the collective approach. Assuming that intentional actors are more deterrable than negligent ones,<sup>109</sup> a stricter form of deterrence is appropriate for self-dealing. Likewise, given that the law favors harsher financial penalties for intentional actors than for negligent ones,<sup>110</sup> a greater likelihood of damages is appropriate for disloyalty. Further, overdeterrence and overcompensation are less of a concern for intentional wrongs such as self-dealing, particularly because a director's disloyalty does not automatically result in liability. As an initial matter, it serves only to rebut the presumptions of the business judgment rule and trigger judicial scrutiny of a challenged transaction. The law's saving mechanisms, particularly entire fairness, will help keep deterrence and compensation in check when courts apply the individual approach in self-dealing cases.<sup>111</sup> If liability is ultimately assessed, typically the penalty will only be disgorgement of the ill-gotten gains.<sup>112</sup>

#### b. Good Faith

The precise nature of good faith has been in flux in the Delaware courts for some time now. Before the Delaware Supreme Court took up the issue in *Disney* and most recently *Stone v. Ritter*,<sup>113</sup> it was unclear whether good faith was inextricably tied to the duty of loyalty, the duty of care, or whether it constituted a third, independent fiduciary duty on equal footing with the other two. Support had been found for each of these

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<sup>108</sup> *Id.* (noting that none of the other directors were independent of Prosser).

<sup>109</sup> See Timothy Stoltzfus Jost and Sharon L. Davies, *The Empire Strikes Back: A Critique of the Backlash Against Fraud and Abuse Enforcement*, 51 ALA. L. REV. 239, 295 (1999) ("Where...the law imposes criminal or civil penalties on intentional conduct...complete deterrence is the proper goal. An intentional actor, by definition, acts with more deliberation and therefore should be more deterrable than a negligent actor."). But see GUIDO CALABRESI, *THE COSTS OF ACCIDENTS*, 133-73 (1970) ("Negligent, no less than intentional, wrongs are fit subjects for deterrence."); Donald C. Langevoort, *Ego, Human Behavior, and Law*, 81 VA. L. REV. 853, 869 (1995) (suggesting that the egos of corporate managers can cause them to underestimate the risks or the wrongfulness of their actions, thereby weakening the deterrent value of legal sanctions).

<sup>110</sup> See W. PROSSER, *HANDBOOK ON THE LAW OF TORTS* 30-31 (4<sup>th</sup> ed. 1971) (greater liability is imposed on the intentional tortfeasor than on the negligent one).

<sup>111</sup> See *supra* notes 65-66 and accompanying text.

<sup>112</sup> See *supra* note 66 and accompanying text.

<sup>113</sup> 2006 WL 3169168.

positions. For example, Sean Griffith cited several “closely reasoned chancery court opinions [that] treat good faith as an aspect of the duty of loyalty,” including *Emerging Communications*.<sup>114</sup> Some opinions, including the Chancery Court’s opinion in *Disney*, had been read to suggest a good faith/due care interplay.<sup>115</sup> And Hillary Sale, most notably, argued that recent Delaware decisions laid the groundwork for recognizing good faith as an independent fiduciary duty.<sup>116</sup>

In *Disney*, the Delaware Supreme Court appeared to establish good faith as an independent fiduciary duty. The court first noted that, despite the recent scholarly writing on the subject, “the duty to act in good faith is, up to this point, relatively unchartered.”<sup>117</sup> Then it stated that “the universe of fiduciary misconduct is not limited to either disloyalty in the classic sense...or gross negligence. A vehicle is needed to address such violations doctrinally, and that doctrinal vehicle is the duty to act in good faith.”<sup>118</sup> Curiously, however, after discussing a duty of good faith and what it entailed, the court hedged in a final footnote reading “we do not reach or otherwise address the issue of whether the fiduciary duty to act in good faith is a duty that, like the duties of care and loyalty, can serve as an independent basis for imposing liability upon corporate officers and directors. That issue is not before us on this appeal.”<sup>119</sup>

The reason for the court’s hedge became clear in *Stone*, a decision issued less than five months after *Disney*. In *Stone*, the court surprisingly

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<sup>114</sup> Griffith, *supra* note 38, at 5 n. 11 (citing cases). See also Johnson, *supra* note 86, at 55 (“Delaware courts have branded conduct falling with the second (‘not in good faith’) exception [to § 102(b)(7)] as implicating loyalty...”).

<sup>115</sup> Griffith observed that Chancellor Chandler focused on the board’s *process* in approving the Ovitz employment agreement, which is essentially a due care analysis, under the rubric of good faith. Griffith, *supra* note 38, at 22-23 (“As in *Van Gorkom*, such allegations would typically form the basis of the complaint under the duty of care, but the court did not pursue this analysis, perhaps because the business judgment rule and the 102(b)(7) provision would have kept it from getting very far.”). Hillary Sale noted the good faith/due care interplay in another well-known Delaware case, *In re Caremark International Inc. Derivative Litigation*. Sale, *supra* note 5, at 467 (“Caremark generated considerable discussion as a duty of care case when issued. It remains an important contribution to the perceived standards of care, but arguably is also one of the cases discussing good faith explicitly in the context of corporate decisionmaking.”).

<sup>116</sup> See Sale, *supra* note 5; Veasey and Di Guglielmo, *supra* note 50, at 1452 (“Professor Hillary Sale...has concluded rather convincingly that good faith is a separate fiduciary duty”). On the emergence the duty of good faith, see also Eisenberg, *supra* note 5; David H. Cook, *The Emergence of Delaware’s Good Faith Fiduciary Duty: In re Emerging Communications, Inc. Shareholders Litigation*, 43 DUQ. L. REV. 91 (2004); Tara L. Dunn, *The Developing Theory of Good Faith in Director Conduct: Are Delaware Courts Ready to Force Corporate Directors To Go Out-of-Pocket After Disney IV*, 83 DENV. U. L. REV. 531 (2005).

<sup>117</sup> 2006 Del. LEXIS 307, \*90.

<sup>118</sup> *Id.*

<sup>119</sup> *Id.* at \*102 n. 112.

reversed course and, with scant explanation, held that good faith was not an independent fiduciary duty, but part of the duty of loyalty.<sup>120</sup> *Stone* was interesting in another respect, for not only did it put good faith under the loyalty heading, but it put the famous *Caremark* “duty to monitor” case,<sup>121</sup> which was widely seen as a subset of the duty of care,<sup>122</sup> under the loyalty heading as well.

While the good faith jurisprudence of late is somewhat strange, good faith as defined by *Disney* (and affirmed by *Stone*) does more closely resemble the traditional duty of loyalty than the duty of care.<sup>123</sup> In *Disney*, the Delaware Supreme Court identified at least three types of bad faith conduct: intentionally acting with a purpose other than that of advancing the best interests of the corporation, intentionally acting to violate applicable positive law, and acting with a conscious and intentional disregard of duties.<sup>124</sup> The first two categories of subjective bad faith are “fiduciary conduct motivated by an actual intent to do harm,”<sup>125</sup> to which the court remarked “such conduct constitutes classic, quintessential bad faith is a proposition so well accepted in the liturgy that it borders on axiomatic.”<sup>126</sup> The third category, a “conscious and intentional disregard of duties,” is a somewhat less obvious type of bad faith, and may have the potential to expand the range of proscribed fiduciary conduct.<sup>127</sup>

For purposes of the individual/collective question, the most important thing to note is that bad faith is currently limited to *intentional* misconduct.<sup>128</sup> Some corporate law scholars would critique *Disney* and

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<sup>120</sup> 2006 WL 3169168, at \*6 (“the obligation to act in good faith does not establish an independent fiduciary duty” but that the duty of loyalty “encompasses cases where the fiduciary fails to act in good faith”).

<sup>121</sup> In re *Caremark International Inc. Derivative Litigation*, 698 A.2d 959 (1996).

<sup>122</sup> See Sale, *supra* note 5, at 467 (“*Caremark* generated considerable discussion as a duty of due care case when issued” and “remains an important contribution to the perceived standards of care”).

<sup>123</sup> In re: Walt Disney Co. Derivative Litigation, 2006 Del. LEXIS 307, at \_\_\_ (rejecting a conflation of the duties of good faith and care).

<sup>124</sup> *Id.* at \*99-100.

<sup>125</sup> *Id.* at \*93.

<sup>126</sup> *Id.*

<sup>127</sup> *Id.* at \*100 (“To protect the interests of the corporation and its shareholders, fiduciary conduct...which does not involve disloyalty (as traditionally defined) but is qualitatively more culpable than gross negligence, should be proscribed.”).

<sup>128</sup> For a post-*Disney* opinion emphasizing the intentionality requirement in bad faith, see *ATM-KIM Eng. Financial Corp. v. Araneta*, 2006 WL 3783520 (Del. Ch.) at \*19 (“imposition of liability requires a showing that the directors knew that they were not discharging their fiduciary obligations”), and *id.* at \*21 (behavior of two directors who failed to monitor inside director and majority shareholder’s self-dealing “was not the product of a lapse in attention or judgment; it was the product of the willingness to serve the needs of their employer...even when that meant intentionally abandoning the important obligations they had taken on”).

*Stone* as defining bad faith too narrowly, and would extend the definition to include egregious acts or derelictions of duty that fall short of intentional misconduct.<sup>129</sup> At least as things stand now, however, the main reason for using an individual director approach in classic disloyalty cases – the intentional nature of self-dealing – also suggests that the individual approach should apply in the new subset of good faith cases. Because bad faith on the part of even one director might inject a harmful bias into the board’s decisionmaking process, courts should favor accountability over authority, and the stricter form of deterrence and compensation, in good faith cases.

## 2. *Duty of Care*

Duty of care claims present a more difficult choice between the individual and collective approaches.<sup>130</sup> Legally, acting with due care means avoiding gross negligence.<sup>131</sup> Practically, it means becoming informed, weighing decisions, and consulting with the appropriate advisors.<sup>132</sup> Despite Delaware’s passage of § 102(b)(7), which allows corporations to exculpate directors from personal liability for duty of care breaches,<sup>133</sup> due care claims may well survive a motion to dismiss and call

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<sup>129</sup> See Sale, *supra* note 5, at 493 (“a breach of good faith need not be intentional or conscious” but “does require some sort of obvious, deliberate, or egregious failure”); Elizabeth Nowicki, *The Unimportance of Being Earnest: Reflections on Director Liability and Good Faith*, draft available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=921668](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=921668) (arguing in favor of liability for actions that are “not in good faith,” even if such actions do not qualify as “bad faith”).

<sup>130</sup> Although corporate law’s duty of care is commonly described as a fiduciary duty, it has been observed that the duty is “not distinctively fiduciary.” Deborah DeMott, *Beyond Metaphor: An Analysis of Fiduciary Obligation*, 1988 DUKE L.J. 879, 915 (duty of care is “not distinctively fiduciary; many persons, by virtue of the law or their own contractual undertakings, owe duties of care to other persons with whom they have nonfiduciary relationships”).

<sup>131</sup> *In re Walt Disney Co. Derivative Litigation*, 2005 Del. Ch. LEXIS 113, 162 (2005) (“duty of care violations are only actionable if the directors acted with gross negligence”).

<sup>132</sup> See Sale, *supra* note 5, at 464-65.

<sup>133</sup> *Del. Code Ann. tit. 8 § 102(b)(7)*. Under this provision, a certificate of incorporation may contain:

A provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, provided that such provision shall not eliminate or limit the liability of a director: (i) For any breach of the director's duty of loyalty to the corporation or its stockholders; (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law; (iii) under § 174 of this title; or (iv) for any transaction from which the director derived an improper personal benefit.

for a choice between the individual and collective approaches after trial. Current law on 102(b)(7) exculpation allows for dismissal of plaintiff's complaint when only due care violations are raised.<sup>134</sup> Therefore, a complaint that also alleges disloyalty or bad faith should preserve the plaintiff's case for trial, given that bad faith or disloyalty can rebut the protective presumptions of the business judgment rule and void a 102(b)(7) clause.<sup>135</sup> In addition, 102(b)(7) clauses do not preclude a choice between the individual and collective approaches in assessing duty of care violations for purposes of granting injunctive relief.<sup>136</sup>

The lack of due care is a wrong of a different nature than disloyalty because it is not intentional. According to Bainbridge, "loyalty...differ[s] in kind, not just in degree, from care....there is a compelling economic justification for insulating allegedly negligent board decisions from judicial review. Few components of that justification carry over to self-dealing or bad faith. Indeed, the affirmative case for disregarding honest errors simply does not apply to intentional misconduct."<sup>137</sup> Likewise, Alison Anderson has remarked that disloyalty may be thought of as more "unfair" than negligence because it entails a "more deliberate form of self-

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Most states have passed legislation similar to § 102(b)(7). See Romano, *supra* note 83, at 30-32 (by 1987, thirty states had passed legislation allowing shareholders to opt into similar protections for directors); ROBERT W. HAMILTON, CORPORATIONS INCLUDING PARTNERSHIPS AND LIMITED LIABILITY COMPANIES: CASES & MATERIALS 783 (7<sup>th</sup> ed. 2001) (by 1999, forty-three states has passed such legislation). Virtually all large U.S. corporations have opted in favor of these protections. See Lawrence A. Hamermesh, *Why I Do Not Teach Van Gorkom*, 34 GA. L. REV. 477 app. a (1999) (finding that in a survey of 100 large U.S. corporations, only 7 did not opt for this protection). *But see* Eisenberg, *supra* note 5, at 1267-68 (contending that § 102(b)(7) and similar provisions have important exceptions).

<sup>134</sup> See Sale, *supra* note 5, at 467 & n. 62 (citing cases).

<sup>135</sup> Under § 102(b)(7), a certificate of incorporation may not limit or eliminate a director's personal liability for "any breach of the director's duty of loyalty...acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law...or...for any transaction from which the director derived an improper personal benefit". See also Veasey and Di Guglielmo, *supra* note 50, at 1441-42 ("if directors 'consciously and intentionally disregarded their responsibilities,' they have not acted in good faith and their conduct will not be protected by the business judgment rule or by section 102(b)(7)").

<sup>136</sup> See *Malpiede v. Townson*, 780 A.2d 1075, 1095 (Del. 2001) (duty of care is not completely eliminated because a court may still grant injunctive relief if directors acted with gross negligence); E. Norman Veasey et al., *Delaware Supports Directors With A Three-Legged Stool Of Limited Liability, Indemnification and Insurance*, 42 BUS. LAW. 399, 403 (1987) (duty of care "will continue to be vitally important in injunction and rescission cases and may well be relevant in elections, proxy contests, resignations, and removal contexts.").

<sup>137</sup> STEPHEN M. BAINBRIDGE, CORPORATION LAW AND ECONOMICS 306 (2002).

preference.”<sup>138</sup> The Delaware Supreme Court also made this distinction clear in *Disney*, explaining that:

Basic to the common law of torts is the distinction between conduct that is negligent (or grossly negligent) and conduct that is intentional. And in the narrower area of corporation law, our jurisprudence has recognized the distinction between the fiduciary duties to act with due care, with loyalty, and in good faith, as well as the consequences that flow from that distinction.<sup>139</sup>

Whether a director’s wrongdoing is intentional or unintentional has important ramifications for the board’s decisionmaking process. There is a more harmful and pervasive quality to a director’s intentional wrongdoing than to her carelessness. Directors acting intentionally have motive to subvert the board’s process to win approval of a transaction that imbues benefits to themselves, in cases of disloyalty, or allow their fellow directors to subvert the process, in some cases of bad faith.<sup>140</sup> Directors acting negligently, on the other hand, are less likely to even participate in the deliberation process given their lack of information about the matters under discussion.<sup>141</sup> By analogy, it is almost as though the negligent director was absent from the board meeting. Yet majority rule permits boards to make decisions and take action without the participation or vote

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<sup>138</sup> Alison Anderson, *Conflicts of Interest: Efficiency, Fairness and Corporate Structure*, 25 UCLA L. REV. 738, 758 n. 59 (1978); see also Johnson, *supra* note 86, at 60 n. 191 (“The element of deliberateness may, as the vice chancellor [Leo Strine] suggests, serve as one partial ‘marker’ for identifying conduct as raising a loyalty issue for purposes of sanctioning inappropriate conduct.”).

<sup>139</sup> 2006 Del. LEXIS 307, at \*99 n. 109. Recognition that intentional wrongdoing is of a different and more-culpable nature than negligence also underlies important provisions of U.S. securities law. See Sale, *supra* note 5, at 489 (“Scienter is a key element of claims pursuant to section 10(b) of the 1934 Securities Act and the accompanying Rule 10b-5 (‘10b-5 claims’).”) (citations omitted).

<sup>140</sup> For instance, in *Emerging Communications* the court acknowledged that attorney/director Raynor may not technically have been disloyal, in the classic self-dealing sense, because he did not directly profit from the privatization transaction, but his complete financial reliance on CEO Prosser – who did directly profit – indicated bad faith. 2004 WL 13057445, at \*39 and nn.183-84. Similarly, although financial expert/director Muoio was not technically disloyal, neither was he independent of Prosser. The court found that this lack of independence, coupled with the fact that the privatization price should have seemed dubious to someone with Muoio’s financial expertise, indicated bad faith. *Id.* at \*39.

<sup>141</sup> Joseph Bonito, a professor of communications who studies participation in small groups, makes this observation. See Joseph A. Bonito, *An Information-Processing Approach to Participation in Small Groups*, 28 COMMUNICATION RESEARCH 275, 279 (2001) (“the more task-relevant information a member possesses, the greater the likelihood that he or she will contribute to the discussion”).

of all directors.<sup>142</sup> Given majority rule, and assuming that a grossly negligent director does little more harm in a meeting through her carelessness than an absentee director does through her absence, the board's process is less affected by a single director acting negligently than one acting intentionally.

Another important difference in the due care setting is the status of the director likely to engage in the misconduct. Inside directors are more likely to have conflicts of interest because they serve the corporation full-time to exclusion of other professional pursuits.<sup>143</sup> On the other hand, they are less likely to be uninformed or otherwise careless given their more intimate knowledge of corporate affairs.<sup>144</sup> Outside directors present the flip side of the coin. They are less likely to have conflicts of interest, but are more likely to be careless given that they devote less attention to the corporation.<sup>145</sup> Despite recent efforts to make outside directors more effective monitors, inside directors continue to enjoy informational and other advantages.<sup>146</sup> For these reasons, outside directors commonly defer to inside directors during deliberations.<sup>147</sup> Given that inside directors

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<sup>142</sup> *Del. Code Ann. tit. 8 § 141(b)* (“The vote of the majority of the directors present at a meeting at which a quorum is present shall be the act of the board of directors unless the certificate of incorporation or the by-laws shall require a vote of a greater number.”).

<sup>143</sup> *See supra* note 52 (distinguishing inside and outside directors).

<sup>144</sup> *See* Roberta Romano, *The Shareholder Suit: Litigation Without Foundation?*, in *FOUNDATIONS OF CORPORATE LAW* 170, 179 (1993) (inside directors are more likely to satisfy their duty of care because they own more corporate stock).

<sup>145</sup> *See* Note, *The Limitation of Directors' Liability: A Proposal for Legislative Reform*, 66 *TEX. L. REV.* 411, 426 (1987) (“outside directors, who are typically without conflicts of interest, must satisfy only a duty of care”).

<sup>146</sup> *See* Lynne L. Dallas, *The Relational Board: Three Theories of Corporate Boards of Directors*, 22 *J. CORP. L.* 1, 4-5 (1996):

One factor that substantially impedes the conflicts monitoring role of the board is the informational dependence of the board on management. Managers have expertise and knowledge of corporate affairs and opportunities available to the corporation. They control meeting dates and the board's agenda, or the identification of matters to be deliberated on by the board. Managers also have access to various lines of communication which permit them to bring the information they choose to the board's attention.

(citation omitted).

<sup>147</sup> *See* Alan J. Meese, *The Team Production Theory of Corporate Law: A Critical Assessment*, 43 *WM & MARY L. REV.* 1629, 1699-1700 (2002) (“by virtue of his or her dominant position within the firm, and position as Chairman of the Board, the CEO can influence, if not control outright, the selection of inside and outside directors. Further, the CEO and other prominent officers are able to control the direction of the board”).

direct the board's deliberations, their fiduciary duty breaches merit greater attention.<sup>148</sup>

If due care breaches are less severe in nature because they involve silent ignorance on the part of less influential outside directors, as opposed to active subversion by more influential inside directors, then we should have confidence in a board's decisionmaking process if *most*, even if not all, directors fulfilled their duty of care. Accordingly, it would allow too much judicial intrusion into the board's process if consequences were to flow from a single director's carelessness, and therefore courts should select the collective approach to assess duty of care claims. In terms of our other normative criteria, aiming deterrence and compensation at individual directors in the due care setting would not matter given § 102(b)(7).<sup>149</sup> Because the available remedy for most due care breaches is now limited to injunctive relief,<sup>150</sup> the fear of personal liability should not deter directors from acting carelessly. Section 102(b)(7) also makes compensation for due care breaches much less likely.

Although the discussion thus far has been limited to how the individual and collective approaches strike the board's authority/accountability balance and further the deterrence and compensation goals underlying fiduciary duty suits, it is also important to consider additional negative effects on the board's functioning that could result from using the individual approach in the due care setting. The consensus-driven decisionmaking process that now exists<sup>151</sup> could turn into a process where directors are pitted against each other (e.g., one director claiming that other directors withheld relevant information) to

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<sup>148</sup> Recognizing a higher standard of care for officers would be one way to account for this problem. See Lyman P.Q. Johnson and David Millon, *Recalling Why Corporate Officers are Fiduciaries*, 46 WM & MARY L. REV. 1597, 1642 (2005) (“[t]here are fewer policy justifications for applying the business judgment rule to officers than directors, just as there are policy factors supporting greater liability risk for officers, compared to directors”) (citation omitted); Wade, *supra* note 6, at 770:

I conclude that courts and attorneys should distinguish analysis of the duty of care owed by corporate executives or managers from the duty of care owed by directors. I suggest an analytical approach that distinguishes the standard of care owed by officers from that owed by directors. Principles requiring reasonableness and rationality govern duty of care analysis for both directors and officers. The standard of care owed by officers and directors is the same, but the amount of care owed by a company's managers, dealing with day to day affairs, is unavoidably higher than the amount of care owed by a company's outside directors, who have far less contact and involvement with the company.

<sup>149</sup> See *supra* notes 133-134 and accompanying text.

<sup>150</sup> See *supra* note 136 and accompanying text.

<sup>151</sup> See *supra* note 9 (citing sources on board decisionmaking by consensus).

avoid culpability.<sup>152</sup> Board minutes might become detailed to the point of showing the role that each director played in deliberations, focusing the directors' attention on personal perseverance rather than the business of the corporation.<sup>153</sup> In cases that go to trial, directors facing individual treatment might request separate counsel due to their individual exposure. This could add to the cost of corporate reimbursement for directors' attorney's fees, and could make trials unruly given an average board size of seven to nine directors.<sup>154</sup> An individual focus could also require courts to itemize and account for individual differences among directors (including a director's insider/outsider status and expert/non-expert qualifications<sup>155</sup>) to assess due care compliance. As a result, both board and judicial efficiency would suffer if an individual approach was applied in duty of care cases. Finally, it is unclear whether an individual approach would be viable for assessing due care breaches, as it might be difficult to establish that the careless director was the proximate cause of any harm.

All of this is not to suggest that we should be unconcerned with a single director's carelessness, or that we should excuse outside directors who do not monitor.<sup>156</sup> The possibility exists that one negligent director, had she been sufficiently informed, could have swayed the board's vote toward an advisable course of action. This hypothetical scenario unfolds in classic movie *12 Angry Men*,<sup>157</sup> albeit in the jury room rather than the boardroom. In that movie, Henry Fonda is the only juror who believes – correctly it turns out – that a criminal defendant is not guilty. He ends up convincing the other jurors, and the jury makes the right decision to acquit. There is anecdotal evidence that even one director can have the same type of effect in a boardroom.<sup>158</sup> While this may be a tempting

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<sup>152</sup> Critics of the move toward greater director independence note the advantages of a collegial board. [cites]

<sup>153</sup> See Samuel N. Fraidin, *Duty of Care Jurisprudence: Comparing Judicial Intrusion and Social Psychology Research*, 38 U.C. DAVIS L. REV. 1, 28-32 (2004) (suggesting that the discovery of notes from board meetings may chill discussions among directors).

<sup>154</sup> See Stephen M. Bainbridge, *Why a Board? Group Decisionmaking in Corporate Governance*, 55 VAND. L. REV. 1, 42 (2002) (“board sizes vary widely. A 1999 survey found that slightly less than half had seven to nine members, with the remaining boards scattered evenly on either side of that range”).

<sup>155</sup> See *supra* notes 51-63 and accompanying text.

<sup>156</sup> Section 11 of the federal Securities Act could be seen as adopting an individual approach for unintentional acts. Section 11 imposes liability on outside directors for material misstatements or omissions in registration statements, yet provides them with an individualized due diligence defense. See 15 U.S.C. § 77(k)(b) (2005); Sale, *supra* note 52, at \_\_\_ (“directors who are active and engaged, who ask questions, and who vet before signing, will not be liable”); William K. Sjostrom, Jr., *The Due Diligence Defense Under Section 11 of the Securities Act of 1933*, 44 BRANDEIS L. J. 549 (2006).

<sup>157</sup> 12 ANGRY MEN (Metro Goldwyn Mayer/United Artists 1957).

reason to favor an individual approach in the due care setting, on balance this approach would do more harm than good by penalizing isolated cases of negligence even if the board as a whole functioned adequately.

A final question must be asked before discussing what a duty-specific answer to the individual/collective question can tell us about fiduciary duties more generally. That is, how is a preference for the collective approach in duty of care cases affected, if at all, by delegation to a board committee?<sup>159</sup> Specifically, to what extent should the full board, which later approves the committee's recommendation, be allowed to rely on the due care exercised by the committee, as opposed to its own due care? On the one hand, corporate law allows boards to establish and delegate to committees,<sup>160</sup> and the board's decision to delegate is protected by the business judgment rule.<sup>161</sup> On the other hand, Bainbridge has identified social science literature that touts the desirability of group decisionmaking, suggesting that we should be hesitant to allow too much delegation if a committee's membership is too small to preserve these benefits.<sup>162</sup> On balance, because committees are likely to have greater knowledge and expertise of matters within their purview, and because they are an accepted part of the corporate governance mechanism, it may be advisable to allow a properly functioning committee to exercise care on

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<sup>158</sup> See Rakesh Khurana and Katharina Pick, *The Social Nature of Boards*, 70 BROOK. L. REV. 1259, 1273 (2005) (noting that “[o]bservers say that even a lone dissenter can make a big difference in the board room” and relaying one story where a single director's hesitation caused the board to reverse their initial approval of an acquisition).

<sup>159</sup> On board committees and their roles, see April Klein, *Firm Performance and Board Committee Structure*, 41 J. L. & ECON. 275, 277-78 (1998).

<sup>160</sup> *Del. Code Ann. tit. 8 § 141(c)*; MBCA § 8.25.

<sup>161</sup> See *Rosenblatt v. Getty Oil Co.*, 493 A.2d 929, 943 (Del. 1985):

An informed decision to delegate a task is as much an exercise of business judgment as any other. The realities of modern corporate life are such that directors cannot be expected to manage the day-to-day activities of a company. This is recognized by the provisions of 8 Del.C. § 141(a) that the business and affairs of a Delaware corporation are managed “by or under the direction” of its board. In setting its agenda as to the matters in which it will be directly involved, and those it will delegate, a board's decisions in those areas are entitled to equal consideration as exercises of business judgment.

(citation omitted).

<sup>162</sup> See Bainbridge, *supra* note 154, at 12-19. Cf. Franklin A. Gevurtz, *The Historical and Political Origins of the Corporate Board of Directors*, 33 HOFSTRA L. REV. 89, 96-97 (2004) (“while the multiple input found in groups often leads to superior decisions than made by a single individual, it is less clear from experimental studies of group decision-making whether this requires the group to act as peers, with disagreements ultimately resolved by majority rule, rather than as a ‘cabinet’ to a single person who has the final say.”). The countervailing fear is that groupthink will become prevalent. See Bainbridge, *supra* note 154, at 32.

behalf of the full board.<sup>163</sup> On the other hand, the decision might depend on the size of the committee and perhaps also the gravity of the matter under review.<sup>164</sup>

#### IV BROADER OBSERVATIONS ABOUT FIDUCIARY DUTIES

If courts are oscillating between an individual and collective focus on directors depending on the type of fiduciary duty at issue, and if this distinction is desirable on corporate governance policy grounds, how does this inform the broader fiduciary duty literature? In particular, what does the courts' answer to the individual/collective question tell us about the role of fiduciary duties as a corporate governance mechanism?

The courts' focus on individual directors in loyalty cases, contrasted with their focus on the board as a whole in due care cases, permits several important observations about fiduciary duties. First, it reveals that the divide between the traditional duties of care and loyalty is even wider than presently acknowledged. Recovery for duty of care breaches is highly unlikely due to the protective provisions of the business judgment rule and the widespread adoption of § 102(b)(7) exculpation clauses.<sup>165</sup> Indeed, by finding no due care violations even in a case like *Disney* that involved highly lax director behavior, the Delaware Supreme Court reaffirmed *Van Gorkom's* status as an outlier in corporate law. If a collective approach to assessing liability requires several grossly negligent directors, rather than just one, it makes the possibility of recovery all the more remote. On the other hand, plaintiffs are generally more successful in classic duty of loyalty claims,<sup>166</sup> and the stricter individual director approach further tips the scales in plaintiffs' favor. Consequently, this contextualized choice of assessment approach reveals a further splintering between the duties of care and loyalty, with courts significantly more likely to impose liability

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<sup>163</sup> On the benefits of committees, see Anup Agrawal & Shiba Chadha, *Corporate Governance and Accounting Scandals* 48 J. L. & ECON. 371 (2005) (empirical study found that audit committees having an independent director with financial expertise issue less financial restatements).

<sup>164</sup> If a committee is comprised of a single member, as is permitted under both Delaware law and the MBCA, the committee's due care should probably not be a substitute for the board's due care. *Del. Code Ann. tit. 8 § 141(c)(1)* ("The board of directors may, by resolution passed by a majority of the whole board, designate 1 or more committees, each committee to consist of 1 or more of the directors of the corporation."); MBCA § 8.25(a) ("a board of directors may create one or more committees and appoint one or more members of the board of directors to serve on any such committee").

<sup>165</sup> See *supra* notes 133-136 and accompanying text.

<sup>166</sup> This was the case even before the enactment of § 102(b)(7). See Tamar Frankel, *Corporate Directors' Duty of Care: The American Law Institute's Project on Corporate Governance*, 52 GEO. WASH. L. REV. 705, 716 (1984) ("Courts do not base their decisions on the duty of care often as they do on the duty of loyalty, but invoke the duty of care in special cases when directors have no conflicts of interest.").

for disloyalty while leaving problems of carelessness to market, reputational, and social sanctions.<sup>167</sup>

Second, this article began by noting that fiduciary duty law currently serves as a weak mechanism for policing directors, and that several corporate law scholars have argued in favor of more robust fiduciary law in the wake of recent corporate scandals.<sup>168</sup> If due care liability will not be revived – and *Disney* suggests that it will not be – another hope for achieving this result was a more explicit duty to act in good faith that could expand or supplement the traditional duties.<sup>169</sup> Although the Delaware Supreme Court has now been more explicit about a requirement to act in good faith, bad faith has been narrowly defined to include only intentional misconduct.<sup>170</sup> Thus while good faith might somewhat expand the grasp of fiduciary law, all unintentional misconduct still appears to be out of reach. By putting good faith on the loyalty side of the dividing line, the Court reaffirmed that fiduciary law is meant to penalize only the most egregious offenders through legal sanctions. Judicial use of an individual approach in these “extreme” cases, compared to a collective approach in all other cases, further assures this separation. Importantly, it also reveals a judicial deemphasis on fiduciary liability as a corporate governance mechanism.

Finally, if courts are dividing the world of fiduciary liability into intentional and unintentional cases, using an individual or collective focus as their tool, why are they not more explicit about this? Each fiduciary duty suit that goes to trial requires a judicial choice between the individual and collective approaches, either explicitly or implicitly. But recall that only three major cases – *Van Gorkom*, *Emerging Communications*, and *Disney* – explicitly speak to this question, and then only superficially.<sup>171</sup> When implicit cases are considered, loyalty’s preference for the individual approach is easier to see than due care’s preference for the collective approach.<sup>172</sup> The question becomes, have courts overlooked the importance of the individual/collective choice in duty of care cases, or is there a reason for only an implicit preference?

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<sup>167</sup> On reputational and social sanctions, see Edward B. Rock, *Saints and Sinners: How Does Delaware Corporate Law Work?*, 44 UCLA L. REV. 1009 (1997); Daniel Fischel, *The Corporate Governance Movement*, 35 VAND. L. REV. 1259, 1287-90 (1982); Einer Elhauge, *Sacrificing Corporate Profits in the Public Interest*, 80 NYU L. REV. 733, 747-56 (2005); David A. Skeel, Jr., *Shaming in Corporate Law*, 149 U. PA. L. REV. 1811 (2001); Eisenberg, *supra* note 66.

<sup>168</sup> See *supra* note 6 and accompanying text.

<sup>169</sup> See *supra* note 5 and accompanying text.

<sup>170</sup> See *supra* notes 124-128 and accompanying text.

<sup>171</sup> See *supra* Part II.A.

<sup>172</sup> See *supra* Part II.B.

The answer might be found in an important discussion distinguishing corporate law's "standards of conduct" from its "standards of liability."<sup>173</sup> Melvin Eisenberg and Gordon Smith have observed that standards of conduct tell directors how to behave, while standards of liability tell judges when to impose liability for director misbehavior.<sup>174</sup> There can be a significant distance between standards of conduct and standards of liability, as illustrated by the duty of care.<sup>175</sup> The standard of conduct tells directors to act with "due care," or "with the care that an ordinarily prudent person would reasonably be expected to exercise in a like position and under similar circumstances."<sup>176</sup> But the standard of liability tells judges to assess liability (or grant injunctive relief) only when the directors' actions are irrational – i.e., not a valid exercise of business judgment.<sup>177</sup> A bifurcated structure thus encourages best practices, but only penalizes unacceptable practices.<sup>178</sup> It aspires for a board that functions perfectly, penalizes a board that functions inadequately, and tolerates a board that falls somewhere in between.

This bifurcated structure fails to work, however, when directors "hear" what is meant to be heard by judges – i.e., standards of liability instead of standards of conduct. Directors who hear laxer standards of liability may be less likely to strive for higher standards of conduct. To maintain bifurcation, at least to the extent possible in the real world, standards of conduct should be made clear, while standards of liability

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<sup>173</sup> See Melvin Aron Eisenberg, *The Divergence of Standards of Conduct and Standards of Review in Corporate Law*, 62 *FORDHAM L. REV.* 437 (1993); Smith, *supra* note 71. This corporate law discussion is based on an important article by Meir Dan-Cohen separating "decision rules" from "conduct rules" in the criminal context. Meir Dan-Cohen, *Decision Rules and Conduct Rules: On Acoustic Separation in Criminal Law*, 97 *HARV. L. REV.* 625 (1984).

<sup>174</sup> See Eisenberg, *supra* note 173, at 465; Smith, *supra* note 71, at 1204.

<sup>175</sup> Eisenberg also observes a distance between the standards of conduct and standards of review in the case of the duty of loyalty. Eisenberg, *supra* note 173, at 464 ("In the area of loyalty...the law's command to directors and officers is the standard of conduct, 'deal fairly when you deal in your own self-interest,' not the standard of review, 'deal as you need to deal to get approval by your colleagues.'").

<sup>176</sup> *ALI PRINCIPLES*, *supra* note 92, at § 4.01.

<sup>177</sup> See Eisenberg, *supra* note 173, at 445-46:

Most of the justifications for the business judgment rule center on liability consequences: in particular, on the potential unfairness of imposing liability for a good decision that turned out badly; on the perverse incentive effects that might result from a reasonability standard of review in liability cases; and on the disproportion between the potential liability for making an imprudent decision and the incentives for serving as an outside director.

<sup>178</sup> As Chancellor Chandler reaffirmed in *Disney*, actual practices can fall far short of best practices without the imposition of liability. 2005 Del. Ch. LEXIS 113, at \*3-8.

should be obfuscated.<sup>179</sup> Accordingly, an explicit adoption of the collective approach in the due care context would run the risk of being heard by directors, thereby telling them of an important barrier to liability. For this reason, Smith rightly critiques the MBCA’s explicit adoption of the collective approach, noting that “[b]y shifting the focus from the individual director to the board as a collegial body, the MBCA *dampens the force of its command*.”<sup>180</sup> Delaware courts, on the other hand, presciently maintain “vagueness in enunciating the decision rule”<sup>181</sup> by only implicitly adopting the collective approach.

## V CONCLUSION

Fiduciary duties are often litigated, and are a favorite topic of discussion among corporate law scholars. This makes it rather surprising that an important question within fiduciary law – whether director liability should be assessed individually or collectively – has been virtually ignored. This article tackles the individual/collective question and sets forth a systematic way of approaching it. It favors a duty-specific answer to this question on both descriptive and normative grounds.

While this article has provided a general framework for answering the individual/collective question, it has also left some specific questions unanswered. For instance, most of the judicial opinions that were discussed in the article were issued after a full trial on the merits. But many fiduciary duty cases do not make it this far, which leaves the question of whether the individual/collective problem presents itself, and in the same way, during the earlier stages of litigation?<sup>182</sup> Also, many factual scenarios resist tidy classification as straight “loyalty” or “due care” cases, which complicates matters. For example, what would the individual/collective analysis look like when a board has adopted questionable takeover defenses against an acquisition, where the

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<sup>179</sup> Eisenberg, *supra* note 173, at 466 (“standards of conduct...should be simple, so that they can be effectively communicated, and to the extent possible should reflect social norms of uprights business behavior that directors and officer scan be expected to know even if they do not know the law”); *id.* (“standards of review may rest on social propositions other than norms of upright business behavior, and correspondingly may be formulated in a more complex manner than standards of conduct”).

<sup>180</sup> Smith, *supra* note 71, at 1213 (emphasis added).

<sup>181</sup> *Id.* at 1206. See also William T. Allen, *Tribute to Chancellor William T. Allen: Ambiguity in Corporation Law*, 22 DEL. J. CORP. L. 894 (1997).

<sup>182</sup> The existing law on demand futility and special committee dismissals must be taken into account here, and not lightly disturbed. See *Aronson v. Lewis*, 473 A.2d 805, 814 (Del. 1984) (basis for excusing demand includes that a majority of the board was disinterested and independent or that the challenged decision was a valid exercise of business judgment); *Zapata Corp. v. Maldonado*, 430 A.2d 779 (Del. 1981) (inquiry into the independence of the special committee).

“enhanced scrutiny” standard requires courts to review the transaction more carefully than due care claims but more deferentially than loyalty claims?<sup>183</sup>

Finally, although this article works within the confines of fiduciary duty suits, the individual/collective question may also be important in other areas of corporate law.<sup>184</sup> According to the *Wall Street Journal*, the individual/collective question might have ramifications for D&O insurance coverage in stock option backdating claims:

In the realm of directors and officers insurance, lawyers are examining whether an insurer can argue that misconduct by a single director or executive in granting or dating stock options can justify refusing to honor coverage for all of the other directors and officers who were involved in making the grant even if they didn't participate in the misconduct.<sup>185</sup>

The individual/collective question is an important one, in fiduciary duty suits and beyond. So far, courts have been answering this question correctly, even if their rationale has been less than forthcoming.

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<sup>183</sup> Under enhanced scrutiny review, the board must show that it had reasonable grounds for believing a threat to corporate policy existed, and that the takeover defenses were a proportionate response to that threat. *See Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985).

<sup>184</sup> One such area is Section 11 of the Securities Act, which adopts something resembling the individual approach. *See supra* note 156.

<sup>185</sup> Peter Lattman, Law Firms Find Backdating Probes are Lucrative, *Wall St. J.*, July 19, 2006, B1, B2.