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DUTY FOLLOWS FUNCTION: TWO APPROACHES TO CURING THE MISMATCH BETWEEN THE FIDUCIARY DUTIES AND POTENTIAL PERSONAL LIABILITY OF CORPORATE OFFICERS

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I. INTRODUCTION

Under Delaware law, corporate directors and officers owe fiduciary duties of care and loyalty to the corporation they serve and its stockholders. In 1986, the Delaware General Assembly amended the General Corporation Law of the State of Delaware

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("DGCL") to add Section 102(b)(7).[1] Section 102(b)(7) permits stockholders of Delaware corporations to exculpate their directors for violations of the duty of care.[2] It does not allow for exculpation of officers. Exculpation was not a true innovation, but was an attempt to restore protection that most corporate commentators, scholars, and practitioners understood to exist prior to the Delaware Supreme Court's decision in *Smith v. Van Gorkom*, rendered in 1985.[3] The exculpation amendment was perhaps the most important public policy contribution the Delaware legislature has made to corporate law apart from adopting the revised General Corporation Law in 1967,[4] but it accomplished an incomplete restoration. The incompleteness has only become apparent recently as the Delaware Supreme Court held that officers owe the same fiduciary duties as directors (included among them, the expansive and misguided duty of care recognized in *Smith v. Van Gorkom*) but cannot be exculpated for the same class of fiduciary breaches as directors.[5]

The concept of limited liability unleashed the efficiencies of separating ownership and control, but the separation can only be wealth-enhancing[6] if the managers in such a regime operate

1. 65 Del. Laws 544 (1986).

2. *See* 1 R. FRANKLIN BALLOTI & JESSE A. FINKELSTEIN, THE DELAWARE LAW OF CORPORATIONS AND BUSINESS ORGANIZATIONS § 1.4, at 1-9 (2d ed. 1996 Supp.) ("Section 102(b)(7) permits the inclusion of a charter provision limiting or eliminating (with certain enumerated exceptions) the liability of directors for violation of their duty of care.").

3. Henry N. Butler, Smith v. Van Gorkom, *Jurisdictional Competition, and the Role of Random Mutations in the Evolution of Corporate Law*, 45 WASHBURN L.J. 267, 268 (2006) ("*Van Gorkom* was a major and seemingly random change in the corporate law of fiduciary duties. It certainly took corporate law observers and commentators by surprise.")(citing Jonathan R. Macey & Geoffrey P. Miller, Trans Union *Reconsidered*, 98 YALE L.J. 127, 131 (1988) ("The outcome of the case was exactly opposite to what virtually every observer of Delaware law would have predicted.").

4. *See* Martin Petrin, *Assessing Delaware's Oversight Jurisprudence: A Policy and Theory Perspective*, 5 VA. L. & BUS. REV. 433, 459 (2011) ("Similarly, DGCL Section 102(b)(7)—arguably the Delaware General Assembly's most important contribution to the corporate liability framework—is also related to risk-taking and board authority.").

5. Gantler v. Stephens, 965 A.2d 695, 708–09 (Del. 2009).

6. We use "wealth-enhancing" in its broadest possible sense to mean a public policy, which tends in general to result in the efficient creation of "societal wealth" as Chancellor Strine has referred to it. *See, e.g.*, Leo E. Strine, Jr., *One Fundamental Corporate Governance Question We Face: Can Corporations Be Managed for the Long Term Unless Their Powerful Electorates Also Act and Think Long Term?*, 66 BUS. LAW. 1, 2 (2010) ("The hoped-for outcome of this risk taking, in the aggregate, is an increase in societal wealth, and not simply through the generation of profits. Rather, to generate profits, corporations have an incentive to employ workers and develop innovative products and services, and to

within a rational incentive structure.[7] Exculpation helped to ensure that directors would not be subjected to personal liability in a way that would undermine the fundamental benefits of limited liability by remelding ownership and control in certain circumstances—namely giving stockholder-owners control when they see in restrospect that management made a mistake.[8]

The fact that Section 102(b)(7) does not allow exculpation of officers[9] can be understood as an historical accident, but, we argue, it is not justified on a public policy basis. The exclusion of officers from exculpation has so far been a sleeping dog, but, if and when it wakes, we believe it would be destructive to the rational incentive structures reclaimed and rebuilt after *Van Gorkom*. We propose two potential remedies. One is simple. We suggest, as others have,[10] that the exculpation statute be amended to extend exculpation to officers. The alternative involves a more fundamental reconsideration of fiduciary duties. We posit that fiduciary duties—owed severally by directors, officers, and controlling stockholders—be expressly differentiated according to the actor's function and what the law should reasonably expect from the actor. To bring coherence to the duties owed by these disparate actors, the courts should recognize that the duty of care of a director is not the duty of care of an officer or the duty of care of a controlling stockholder.

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engage in other activities that increase societal wealth."). It does not refer to enhancement of the wealth of particular people or even particular firms. That is, we start from the basic premise that a public policy should tend to improve the overall picture without regard for how it might affect a particular person or firm and argue that officer exculpation is such a policy.

7. By rational incentive structure we mean one which minimizes agency costs. *See* Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288, 288–89 (1980).

8. The remelding would be effected by the courts, but it is on behalf of stockholders seeking to reassert their ability to control the corporation. *See* James J. Hanks, Jr., *Evaluating Recent State Legislation on Director and Officer Liability Limitation and Indemnification*, 43 BUS. LAW. 1207, 1208 (1988) ("[T]he courts became increasingly willing to second-guess directors' decisions, culminating in the now well-known case of *Smith v. Van Gorkom*."); Mark David Wallace, *Life in the Boardroom after FIRREA: A Revisionist Approach to Corporate Governance in Insured Depository Institutions*, 46 U. MIAMI L. REV. 1187, 1237 n.303 (1992) ("In effect, under *Trans Union*, courts could second-guess managerial business judgment as to the method and choice of business deliberation.").

9. See *infra* note 57 for full text of Section 102(b)(7).

10. *See, e.g.*, Dennis R. Honabach, Smith v. Van Gorkom*: Managerial Liability and Exculpatory Clauses—A Proposal to Fill the Gap of the Missing Officer Protection*, 45 WASHBURN L.J. 307, 324–25 (2006). *Contra* Michael Follett, Gantler v. Stephens*: Big Epiphany or Big Failure? A Look at the Current State of Officers' Fiduciary Duties and Advice for Potential Protection*, 35 DEL. J. CORP. L. 563, 580 (2010) ("[W]e do not need expanded exculpatory protection [for officers].").

Indeed, a duty of care for a controlling stockholder makes no sense at all. Once properly fashioned according to an officer's role, the duty of care would not give rise to a significant risk of inappropriate personal liability against officers. The alternatives to addressing the issue are not mutually exclusive and the best approach is likely to amend the statute and also begin to recognize differentiated fiduciary duties.

II. GENESIS AND EVOLUTION OF EXCULPATION

A. *Limited Liability, the Separation of Ownership and Control, and the Business Judgment Rule*

Corporations require certain fundamental features to exist as they do. Among these are "formal creation as prescribed by state law; legal personality; separation of ownership and control; freely alienable ownership interests; indefinite duration; and limited liability."[11] The concepts behind the modern corporation and the key feature of limited liability for stockholders developed in the nineteenth century.[12] The limitation on liability meant that a stockholder could entrust a portion of his or her wealth to a manager and only risk the particular amount of the investment. This had various positive spillover effects.

As the limitation on liability became more entrenched and understood, the stockholder came to know with certainty how much he or she could lose as contrasted with an unlimited liability regime. Under an unlimited liability regime, which coexisted with the limited liability corporation for a period,[13] the probability and amount of potential stockholder liability would depend on how the enterprise was operated. If it was managed poorly such that it became insolvent, the stockholders could lose more than the amount invested.[14] This potential liability stifled

11. STEPHEN M. BAINBRIDGE, CORPORATION LAW AND ECONOMICS 2 (2002) (citations omitted).

12. Herbert Hovenkamp, *The Classical Corporation in American Legal Thought*, 76 GEO. L.J. 1593, 1651–53 (1988).

13. In the early nineteenth century, "reflecting the critical public attitude toward corporations, legislation was enacted that specifically provided for unlimited liability. For example, the Manufacturing Act of 1809 in Massachusetts stated that '. . . if execution against the corporation could not be satisfied out of corporate property, it might, after a lapse of fourteen days, be levied on the body or property of any members.'" WILLIAM H. HUSBAND & JAMES C. DOCKERAY, MODERN CORPORATION FINANCE 36 (4th ed. 1957).

14. *See* Henry G. Manne, *Our Two Corporation Systems: Law and Economics*, 53 VA. L. REV. 259, 262 (1967) ("One of the great advantages of the large corporate system is that it allows individuals to use small fractions of their savings for various purposes, without risking a disastrous loss if any corporation in which they have invested becomes insolvent.").

investment because the amount of liability was unknown and depended on unknowable factors.[15] This lack of knowledge forced the stockholder to keep wealth in reserve with respect to an enterprise (without actually investing the wealth in the enterprise and gaining a return on it) because his existing investment created potential liability beyond the amount invested.[16] With so much depending on the way the enterprise was operated, a capital participant would rationally either expend additional capital to participate directly in its operation or to monitor its operation closely.[17]

Limited liability gave stockholders the assurance that they could lose only the amount they invested. With risk cabined, the stockholder was free to commit other capital to other ventures.[18] Because limited liability lowered the stakes by putting a cap on liability, it became less rational to expend one's own uncommitted wealth on monitoring and participating in each venture,[19]

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15. *See id.* ("But the possibility of liability arising at an unforeseen time and in an unpredictable amount would probably be too great a risk for large numbers of small investors to shoulder."); *see also* Margaret M. Blair, *Locking in Capital: What Corporate Law Achieved for Business Organizers in the Nineteenth Century*, 51 UCLA L. REV. 387, 440 (2003) ("Limited liability also allows for individuals with limited wealth to invest in small amounts, without subjecting themselves to potentially catastrophic liabilities.").

16. *See* Frank H. Easterbrook & Daniel R. Fischel, *Limited Liability and the Corporation*, 52 U. CHI. L. REV. 89, 94 (1985) ("Those who invest capital can bear additional risk, because each investor is free to participate in many ventures. The holder of a diversified portfolio of investments is more willing to bear the risk that a small fraction of his investments will not pan out.").

17. Hovenkamp, *supra* note 12, at 1658 ("Inevitably, limited shareholder liability also encouraged limited shareholder involvement by encouraging them to be less concerned about the corporation's affairs. Limited liability was another of many doctrines, inherent in the classical theory of the corporation, that gradually gave responsibility for the corporation's affairs to management rather than to ownership.").

18. *Id.* at 1656.

> Limited liability greatly facilitated the flow of capital into new investments by allowing an entrepreneur with $50,000 in assets to invest $1,000 in a new incorporation without risking the other $49,000.
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> The classical, limited liability corporation was the preeminent nineteenth century risk-sharing device. It broadened the risk of failure to creditors as well as investors. In the process, limited liability encouraged further separation of ownership from control by attracting the "silent" investor, one with money to risk, but who did not wish to have to concern himself with the corporation's daily affairs.

Id.

19. *See* Easterbrook & Fischel, *supra* note 16, at 94 ("All investors risk losing wealth because of the actions of agents. They could monitor these agents more closely. The more risk they bear, the more they will monitor. But beyond

particularly since that freed-up capital could be committed to ventures that would have a higher rate of return than the investment in monitoring existing investments.[20] Thus, the economic rationale for direct participation in management[21] by stockholders (to avoid a catastrophic liability event) dissipated and stockholders gave way to professional management to fill the role of exercising control over the corporation while the stockholder monitored management in a more hands-off way.[22] Ownership and control, thus, became separated. As corporations evolved during the later nineteenth century and first half of the twentieth, the benefits of concentrating control over the corporation in its management became ever more apparent. Left to manage the corporation as they saw fit, management became increasingly expert and effective.[23]

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a point more monitoring is not worth the cost."); Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301, 309 (1986) ("When there are many residual claimants, it is costly for all of them to be involved in decision control and it is efficient for them to delegate decision control.").

20. Fama, *supra* note 7, at 295.

> When management and risk bearing are viewed as naturally separate factors of production, looking at the market for risk bearing from the viewpoint of portfolio theory tells us that risk bearers are likely to spread their wealth across many firms and so not be interested in directly controlling the management of any individual firm.

Id.

21. This management role was bifurcated into a board of directors which set corporate policy and officers who carried out those policies and operated the corporation day-to-day. The distinctions between these two sub-roles is discussed *infra* Part III. In this Part, we use "management" to refer to the collective board and officer functions.

22. With the advent of institutional stockholders with hundreds and thousands of investments, stockholders have now delegated the monitoring of the management of the corporation. This delegation of monitoring does not promise the efficiencies of the delegation of operations and may even undermine the delegation of operations and the desirable freedom of action granted to management. The monitors have professionalized the monitoring functions that stockholders gave up in the late nineteenth and early twentieth centuries when they moved away from close monitoring (and second-guessing) of management. Whereas it became inefficient for stockholders to closely monitor multiple investments, the monitors are able to do this without the same cost barriers because of the technological advances in the tools necessary to monitor management. *See also* Stephen M. Bainbridge, *Competing Concepts of the Corporation (a.k.a. Criteria? Just Say No)*, 2 BERKELEY BUS. L.J. 77, 90–91 (2005) (observing that, if the mechanical obstacles to mass stockholder participation "could be overcome, active shareholder participation in corporate decision making would still be precluded by the shareholders' widely divergent interests and distinctly different levels of information").

23. *See* William T. Allen, et al., *Function Over Form: A Reassessment of Standards of Review in Delaware Corporation Law*, 56 BUS. LAW. 1287, 1288 (2001)

The keystone of this regime was the business judgment rule. It is not surprising that the business judgment rule developed in conjunction with limited liability and the further separation of ownership and control,[24] because the business judgment rule is a corollary to those concepts. The business judgment rule sets the fundamental parameters within which control can be exercised. It forms a sort of compact between the stockholders and the management to whom they are entrusting their capital.[25] The compact is that management will be permitted to use the stockholders' capital to operate the corporation in their best judgment without second-guessing by the stockholders (using the courts as the vehicle for such second-guessing) so long as management does so in pursuit of the corporation's best interests. In other words, the stockholder gives up his wealth to the corporation and irrevocably confers discretion on management to employ that wealth profitably.[26] Stockholders can only revoke the discretion if management undermines this compact by not actually pursuing the best interests of the corporation. In this way, the business judgment rule prevents stockholders from reneging on their part of the bargain—giving up control over their wealth—whenever the stockholders see, in retrospect, that the management they entrusted made a business mistake. If made in rational pursuit of the corporation's best interests, management is protected from second-guessing and from liability for losses.

("[The corporate] organizational form also allows the separation of the operating management role from the role of providing risk capital, facilitates the specialization of function, and affords owners of capital the great benefits of inexpensive diversification."); Bainbridge, *supra* note 22, at 92 ("In order to reap the benefits of managerial specialization, all other corporate constituents should prefer to specialize in functions unrelated to decision making, such as risk bearing (shareholders) or labor (employees), delegating decision making to managers.").

24. Hovenkamp, *supra* note 12, at 1667–69 (describing the differing views of courts in the late nineteenth century over the proper formulation of the business judgment rule).

25. eBay Domestic Holdings, Inc. v. Newmark, 16 A.3d 1, 36 (Del. Ch. 2010) (quoting Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d 1361, 1373 (Del. 1995)).

> Under the business judgment rule, when a party challenges the decisions of a board of directors, the Court begins with the "presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company."

Id.

26. *See* Blair, *supra* note 15, at 390.

This locking-in mechanism of the business judgment rule is critical to ensure that separating ownership from control creates incentives directed toward wealth creation and does not destroy management's incentive to take risks to achieve profit. Wealth creation requires taking risk, but inherent in taking risk is the possibility of failure.[27] If not given the benefit of the business judgment rule (in other words, if forced to bear the brunt when things turn out poorly), management would not rationally take risks, even risks that were more likely to be successful than unsuccessful.[28]

The necessity of the business judgment rule to align incentives can be simply illustrated. Imagine a business opportunity that was sixty percent likely to create $100 of profit for a corporation and forty percent likely to result in a loss of $50. All things equal, if he is protected from second-guessing, a manager would weigh the potential gain (0.6 x $100 = $60) against the potential loss (0.4 x -$50 = -$20) and pursue the opportunity. The body corporate, could it find its voice, would rationally direct the manager to take the opportunity because it was good for the corporation on balance. If the manager may have to pay some part of the $50 loss to the stockholders in the event of failure, the manager would obviously be less inclined to take the opportunity for the corporation and would likely not take the opportunity at all if the potential liability was at all likely. The business judgment rule thus aligns the incentives of the manager and the corporation ex ante by ensuring that in the event the opportunity turns out poorly ex post, the stockholders (who would have rationally directed management to take the opportunity) cannot try to

27. "The business judgment rule is 'the first protection against a threat of suboptimal risk acceptance'; that is, it mitigates the problem that the prospect of personal liability can cause directors, in authorizing corporate investments, to be more risk-averse than the interest of diversified shareholders would dictate." Petrin, *supra* note 4, at 458 (quoting Gagliardi v. Trifoods Int'l, Inc., 683 A.2d 1049, 1052 (Del. Ch. 1996)).

28. "If law-trained judges are permitted to make after-the-fact judgments that businesspersons have made 'unreasonable' or 'negligent' business decisions for which they must respond in monetary damages, directors may, in the future, avoid committing their companies to potentially valuable corporate opportunities that have some risk of failure." William T. Allen, Jack B. Jacobs & Leo E. Strine, Jr., *Realigning the Standard of Review of Director Due Care with Delaware Public Policy: A Critique of* Van Gorkom *and Its Progeny as a Standard of Review Problem*, 96 Nw. U. L. Rev. 449, 449 (2002). Note that this does not depend on the fact that the judges are not trained in business. The judges on the Court of Chancery see enough business disputes that they become very sophisticated, but that does not put them in a better position to second-guess than other less experienced judges. It is the second-guessing aspect rather than the inexpert aspect that makes judicial second-guessing a bad policy.

recover part of their loss from management. So long as management was pursuing the interests of the corporation in good faith, they cannot be punished for mistakes and forced to provide investors insurance for stockholders.

Thus, in this admittedly simplified version of the birth of the modern corporation, limited liability developed in parallel with the separation of ownership and control, which was then complemented by the business judgment rule. Such was the state of affairs in corporate governance that had evolved and stabilized by the early 1980s. The Delaware Supreme Court decision of *Smith v. Van Gorkom*[29] upset this pastoral picture in a fundamental way by subjecting directors to personal liability even when they had acted in good faith pursuit of the corporation's best interests. That is, management was subjected to liability under the circumstances when they believed they were protected from second-guessing and insuring against stockholder loss. The court did this by animating the duty of care.

B. *Exculpation as Child of* Smith v. Van Gorkom

Before *Smith v. Van Gorkom*, the duty of care had been "essentially unenforceable as a stand-alone concept," but *Van Gorkom* made it into "an enforceable duty that came to occupy a more central place on the corporate law stage."[30] Exculpation became necessary to re-establish the business judgment rule and patch the hole created by *Smith v. Van Gorkom*.[31] Perhaps because the *Van Gorkom* decision only spoke to the defendants as directors, the legislative patch was only placed over the new expo-

29. 488 A.2d 858 (1985).

30. Allen, et al., *supra* note 23, at 1291.

31. *Id.* at 1300 n.49 ("[The D&O crisis] required a legislative solution, i.e., the adoption of DEL. CODE ANN. tit. 8, § 102(b)(7) . . . .").

> Few corporate governance issues are more important than the availability of sufficient insurance at affordable prices. Without sufficient insurance, qualified individuals may decline service as corporate directors because the potential for liability is so vastly disproportionate to the benefits directors typically receive in return for their service. The result could be an exodus of talented directors and potential directors from corporations unable to secure sufficient insurance—a phenomenon that was reported at the height of the D&O [directors and officers] crisis of the mid-1980s—and an unhealthy over-cautiousness on the part of individuals who do remain in corporate directorships. As stated by the drafters of the Model Business Corporation Act: "Developments in the mid- and late 1980s highlighted the need to permit reasonable protection of directors from exposure to personal liability, in addition to indemnification, so that directors would not be discouraged from fully and freely carrying out their duties, including responsible entrepreneurial risk-taking."

sure in director liability and, to the extent *Van Gorkom* increased the risk of officer liability, it was left undisturbed.

The directors of Trans Union in *Van Gorkom* were faced with a decision to sell the company. The CEO, Jerome Van Gorkom, without consulting the board, had begun to seek acquirors in order to capture the value of the company's tax credits.[32] In his own mind, he had apparently already settled on a price of $55 per share.[33] After somewhat cursory negotiations with a single bidder, the CEO presented the board with a proposed merger at $55.[34] The substance of the presentation was almost entirely oral; there was not sufficient time to consider what little written material was available.[35] In the course of the two-hour meeting, the board decided to sell the company. The Delaware Supreme Court ultimately held that, in doing so, the directors had breached their duty of care.

Van Gorkom arose before the major takeover cases of *Revlon*[36] and *Unocal*[37] were decided and thus, in judging how directors should manage the sale process, the court was faced with issues no other court had wrestled with.[38] The court held that the board's duty required "more than the mere absence of bad faith or fraud. Representation of the financial interests of others imposes on a director an affirmative duty to protect those interests."[39] The fundamental problem with the decision was that the court imposed monetary liability on directors for a good faith business judgment. There was no dispute that the directors had acted in good faith when deciding to sell Trans Union.[40] The court found that despite their good faith, the directors had violated their duty of care because they did not "have before them adequate information regarding the intrinsic value of the Company, upon which a proper exercise of business judgment could

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STEPHEN A. RADIN, IV THE BUSINESS JUDGMENT RULE: FIDUCIARY DUTIES OF CORPORATE DIRECTORS 5592–93 (6th ed. 2009) (quoting 1 Model Bus. Corp. Act Annotated § 2.02 Official Comment at 2–16 (4th ed. 2008)).

32. Van Gorkom, 488 A.2d at 865–866.

33. *Id.*

34. *Id.*

35. *Id.* at 868.

36. Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986).

37. Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985).

38. "[I]t is striking how clean the slate was—how little guidance the Delaware Supreme Court had—when *Van Gorkom* was decided." Lawrence A. Hamermesh, *A Kinder, Gentler Ctritique of* Van Gorkom *and Its Less Celebrated Legacies*, 96 Nw. U. L. REV. 595, 596 (2002).

39. *Van Gorkom*, 488 A.2d at 872.

40. *Id.* at 873.

be made," and as a result, "failed to act with informed reasonable deliberation in agreeing to the Pritzker merger proposal."[41] To foreclose courts from looking over directors' shoulders in this way, exculpation for violations of the duty of care was conceived.

There were a number of contributing factors to the birth of Section 102(b)(7) and *Van Gorkom* was not the sole cause, but it was the most important. The stated rationale for exculpation was to allow Delaware corporations to attract qualified directors, a task made difficult or impossible by the prevailing D&O crisis and exacerbated by *Van Gorkom*.[42] Over the ten-year period leading up to that decision in 1985, the cost of directors and officers insurance policies had risen by 200% for some corporations.[43] This had an effect on the corporations seeking qualified directors, but it was *Van Gorkom* itself that fundamentally changed the market for directors.[44] The case tipped the balance against accepting a directorship because the potential detriment could outweigh the benefits of becoming a director and the downside risk was inherently unknowable.[45] Why take a director position if a court will impose personal liability even if you were trying to do the right thing?

One noteworthy aspect of *Van Gorkom* is that many of the central players in the case were not only directors but officers as well.[46] Five of the ten directors on the Trans Union board were officers,[47] but the court did not differentiate between inside ver-

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41. *Id.* at 881.

42. *See* 65 Del. Laws 544 (1986); 1 BALOTTI & FINKELSTEIN, *supra* note 2.

43. Roberta Romano, *Corporate Governance in the Aftermath of the Insurance Crisis*, 39 EMORY L.J. 1155, 1158 (1990). Some commentators have questioned whether the D&O crisis was real. *See* J. Robert Brown, Jr. & Sandeep Gopalan, *Opting Only In: Contractarians, Waiver of Liability Provisions, and the Race to the Bottom*, 42 IND. L. REV. 285, 303 (2009). Whether the D&O crisis was real, whether Section 102(b)(7) was really adopted to make D&O insurance more available, and whether it succeeded in doing so are secondary, in our view, to the central purpose of Section 102(b)(7), which was and ought to have been, to rebalance the incentives that *Smith v. Van Gorkom* skewed.

44. "In the 1985 landmark decision of *Smith* v. *Van Gorkom*, however, the Delaware Supreme Court blew a hole in the board's traditional shield, holding that the business judgment rule does not protect directors from monetary liability for acts of gross negligence." Kristin A. Linsley, Comment, *Statutory Limitations on Directors' Liability in Delaware: A New Look at Conflicts of Interest and the Business Judgment Rule*, 24 HARV. J. ON LEGIS. 527, 527 (1987).

45. "Highly qualified directors may also avoid service if they face liability risks that are disproportionate to the benefits of service." Allen, Jacobs & Strine, Jr., *supra* note 28, at 449.

46. Smith v. Van Gorkom, 488 A.2d 858, 867–69 (Del. 1985) (describing negotiation of merger agreement and involvement of Trans Union CEO and other officers).

47. *Id.* at 868.

sus outside directors nor did it attempt to parse the different capacities of the directors who were also officers.[48] The court's findings were delivered as judgments against the Board as a unified whole[49] despite arguments having been addressed as to "whether one or more of the outside directors were entitled to invoke the protection of 8 *Del. C.* §141(e) by evidence of reasonable, good faith reliance on 'reports,' including legal advice, rendered the Board by certain inside directors and the Board's special counsel."[50] The court, thus, never discussed whether any of the officers who were directors could have been liable for breach of fiduciary duty in their capacity as officers. Nor did the court suggest what the content of such duties might be even though much of the CEO's described conduct involves Mr. Van Gorkom carrying out duties of an officer.[51]

C. *Section 102(b)(7) Takes Shape*

The Delaware legislature responded quickly to *Smith v. Van Gorkom.*[52] The decision was rendered on January 29, 1985.[53] During the legislative session in the following year, the General Assembly enacted Section 102(b)(7) to remedy the problems cre-

48. This may have been due to defense counsel's position that all nine defendants should be treated exactly the same and that there was no "distinction between Chelberg [President and Chief Operating Officer of Trans-Union] and Van Gorkom [Chairman and CEO] vis-à-vis the other defendants . . . whatsoever." *Id.* at 899 (relating oral argument colloquy).

49. "[S]ince 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 . . . ." *Id.* at 889. "[T]he board perhaps deserves some blame, but the lion's share of the blame for any harm imposed on shareholders by the Trans Union-Pritzker merger falls on the shoulders of Van Gorkom, rather than the Trans Union board." Jonathan R. Macey, 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 (2002).

50. *Id.* at 888–89. Section 141(e) of the DGCL permits directors to be fully protected in "relying in good faith . . . upon such information, opinions, reports or statements presented to the corporation by any of the corporation's officers . . . ." DEL. CODE ANN. tit. 8, § 141(e) (2001).

51. *See, e.g., Van Gorkom,* 488 A.2d at 867 (presiding over management meeting); *Id.* at 869 (executing merger agreement). This is not a special gap in *Van Gorkom*'s analysis. Later cases have likewise been silent or ambiguous as to such distinctions.

52. Only Indiana was faster in the race to counter the effect of *Van Gorkom.* Fred S. McChesney, *A Bird in the Hand and Liability in the Bush: Why* Van Gorkom *Still Rankles, Probably,* 96 Nw. U. L. REV. 631, 649 (2002).

53. *Van Gorkom,* 488 A.2d at 858.

ated by the decision.[54] The statute was enacted in the same way that amendments to the DGCL are generally handled.[55] The issue was studied and legislation drafted by the Council of the Corporation Law Section of the Delaware State Bar Association and then presented to the legislature.[56] Reflective of the care which was taken at the time to draft an appropriate remedy to *Van Gorkom,* since 1985, Section 102(b)(7) has been amended only twice.[57]

The original Section 102(b)(7) provided in its last sentence as follows: "All references in this subsection to a director shall also be deemed to refer to a member of the governing body of a corporation which is not authorized to issue capital stock."[58] In 1993, this portion of the statute was amended to read as follows:

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54. "The new section 102(b)(7) is intended to assist Delaware corporations attract and retain highly qualified individuals to serve as directors." R. Franklin Balotti & Mark J. Gentile, *Commentary from the Bar: Elimination or Limitation of Director Liability for Delaware Corporations,* 12 DEL. J. CORP. L. 5, 5 (1987); *see also* Honabach, *supra* note 10, at 311–12.

55. For a discussion of the details of this process, see generally Lawrence A. Hamermesh, *The Policy Foundations of Delaware Corporate Law,* 106 COLUM. L. REV. 1749 (2006).

56. Curtis Alva, *Delaware and the Market for Corporate Charters: History and Agency,* 15 DEL. J. CORP. L. 885, 914 (1990) (describing disagreement within Delaware State Bar relative to adoption of Section 102(b)(7)); Balotti & Gentile, *supra* note 54, at 9–11; Leo E. Strine, Jr., et al., *Loyalty's Core Demand: The Defining Role of Good Faith in Corporation Law,* 98 GEO. L.J. 629, 661–63 (2010) (relating drafting history of Section 102(b)(7)).

57. Section 102(b)(7) currently provides in its entirety as follows:

> In addition to the matters required to be set forth in the certificate of incorporation by subsection (a) of this section, the certificate of incorporation may also contain any or all of the following matters:
>
> > (7) 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. No such provision shall eliminate or limit the liability of a director for any act or omission occurring prior to the date when such provision becomes effective. All references in this paragraph to a director shall also be deemed to refer to such other person or persons, if any, who, pursuant to a provision of the certificate of incorporation in accordance with § 141(a) of this title, exercise or perform any of the powers or duties otherwise conferred or imposed upon the board of directors by this title.

DEL. CODE ANN. tit. 8 § 102(b)(7) (2001 & Supp. 2010).

58. 65 Del. Laws 544 (1986).

All references in this paragraph to a director shall also be deemed to refer (x) to a member of the governing body of a corporation which is not authorized to issue capital stock, and (y) to such other person or persons, if any, who, pursuant to a provision in the certificate of incorporation in accordance with subsection (a) of § 141 of this title, exercise or perform any of the powers or duties otherwise conferred or imposed upon the board of directors by this title.[59]

The addition of clause (y) in 1993 could have given rise to the following argument: exculpation could be extended to officers if, pursuant to Section 141(a), they were authorized in the certificate of incorporation to "exercise or perform any of the powers or duties otherwise conferred or imposed upon the board of directors" in the corporation's charter.[60] The contemporary view of the addition to Section 102(b)(7) in 1993 was contrary to that argument. The view was that the amendment did not so extend exculpation to officers, except insofar as an officer was "exercis[ing] the authority of a director."[61] Moreover, the Delaware Supreme Court all but foreclosed that argument when it noted in *Gantler* that "[a]lthough legislatively possible, there currently is no statutory provision authorizing comparable exculpation of corporate officers."[62] Such an extension certainly is not a comfortable fit given the specific references to directors in Section 102(b)(7) and the absent references to officers. Thus, while it may have been possible to argue that Section 102(b)(7) protection could be extended to officers after 1993, the prevailing interpretation is firm that Section 102(b)(7) cannot extend protection to officers as currently drafted.

Section 102(b)(7) was also amended in 2010 to remove the reference to non-stock corporations,[63] but no further substantive revision has been deemed necessary. Thus, despite leaving officers without the shield of exculpation, Section 102(b)(7) has

59. 69 Del. Laws 54 (1993).

60. § 102(b)(7); § 141(a) ("[T]he powers and duties conferred or imposed upon the board of directors by this chapter shall be exercised or performed to such extent and by such person or persons as shall be provided in the certificate of incorporation.").

61. Barry J. Benzing, Note, *1993 Statutory Amendments to the Delaware General Corporation Law*, 19 DEL. J. CORP. L. 560, 562 (1994).

62. *See, e.g.*, Gantler v. Stephens, 965 A.2d 695, 709 n.37 (2009).

63. Act to Amend Title 8 of the Delaware Code Relating to the General Corporation Law § 6 (2010), http://delcode.delaware.gov/sessionlaws/ga145/Chp253.pdf. This was not a substantive change as the addition of Section 114 of the DGCL in the same legislation preserved the ability of non-stock corporations to exculpate members of their governing bodies.

withstood twenty-five years with effectively no revision from the corporate bar.

D. *Why Officers Were Left Behind*

In other legislative environments, officers may have been excluded simply because of a legislative oversight. That was not the case for Section 102(b)(7). The corporate bar who drafted the statute knew in 1986 that officers were not protected by Section 102(b)(7),[64] but *why* they were left behind is not completely clear.

There were circumstances existing in 1986 that would have favored including officers under the exculpation provisions. As discussed above, the key players in *Van Gorkom* were also officers.[65] Certain parts of the opinion indicate that one of the main problems the Court saw with the Trans Union transaction was that Van Gorkom, as CEO, orchestrated the entire transaction with too little board involvement.[66] Insofar as he did orchestrate the transaction, he would have been conducting many of the movements in his capacity as CEO rather than as a director. In addition, cases decided before 1986 were clear that officers also owed fiduciary duties to the corporation's stockholders. Thus, if directors' duties were expanded improvidently in *Van Gorkom*, by implication, the same was true of officers, and officers were thereby just as exposed to liability as directors.[67]

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64. Balotti & Gentile, *supra* note 54, at 8–10.

65. *Van Gorkom*, 488 A.2d at 894 (discussing board membership and qualifications) (McNeilly, J., dissenting).

66. "The directors . . . did not adequately inform themselves as to Van Gorkom's role in forcing the 'sale' of the Company and in establishing the per share purchase price . . . ." *Id.* at 874.

67. See Diamond State Iron Co. v. Todd, 14 A. 27, 32–33 (Del. Ch. 1888).

> The defendant Todd, as secretary, officer, and agent of the company, stood towards the company, its stockholders, and towards McCullough as a stockholder, in a fiduciary relation . . . . The principle applies to directors of corporations. The same principle has been applied to the case of a paid manager or servant of a bank who was not a director.

Id. (citations omitted); Harden v. E. States Pub. Serv. Co., 122 A. 705, 706 (Del. Ch. 1923).

> The allegations of the bill which charge mismanagement of the corporate assets must be taken to mean that such mismanagement has been on the part of the officers of the corporation. While the corporation is the owner of the assets, yet their control and management rest in the officers and directors, whose relation to the assets is one of a fiduciary character. This is elementary.

Id.; Guth v. Loft, Inc., 5 A.2d 503, 510 (Del. 1939) ("Corporate officers and directors are not permitted to use their position of trust and confidence to further their private interests. While technically not trustees, they stand in a

Part of the reason officers were left behind may be attributable to the law of personal jurisdiction. Delaware is the legal home to most of this country's large corporations, but very few of the directors and officers of those corporations call Delaware home. Delaware adopted a sequestration statute that permitted plaintiffs to sequester stock directors owned in the subject corporation if they failed to appear in such actions. Directors who were sued in Delaware for breach of fiduciary duty challenged the state's personal jurisdiction to hear the cases, and the United States Supreme Court struck down that law in *Shaffer v. Heitner* as violating the Due Process Clause of the Fourteenth Amendment.[68]

In response, the Delaware legislature passed Section 3114 to address the constitutional defects the Supreme Court identified in the sequestration statute.[69] Section 3114 provides that persons who accept service as a director of a Delaware corporation after September 1, 1977 or who serve in such capacity after June 30, 1978 are deemed thereby to have consented to the jurisdiction of the Delaware courts to adjudicate issues arising from that service.[70] Absent traditional bases of personal jurisdiction, however, Delaware courts could not hale *officers* of Delaware corporations into their courts under Section 3114—officers would be able to cite *Shaffer* as precluding the exercise of such jurisdiction.[71] Thus, it is possible that protection under Section 102(b)(7) was deemed unnecessary because officers generally could not be haled before the Delaware courts.

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fiduciary relation to the corporation and its stockholders."); *cf.* Lofland v. Cahall, 118 A. 1, 8 (Del. 1922).

> In the absence of actual fraud in the transaction, the judgment of the directors, as to the value of such labor, property, real estate or leases, shall be conclusive.
>
> But it is obvious that by "directors" the Legislature meant officers who were competent to represent the company in making the valuation, and not those who were personally interested in the valuation, and, therefore, wholly incompetent to represent the company in the transaction.

Id. (citations omitted).

68. 433 U.S. 186, 216–17 (1977).

69. 61 Del. Laws 328 (1977).

70. DEL. CODE ANN. tit. 10, § 3114(a) (1999).

71. *See* Jack B. Jacobs, *Personal Jurisdiction Over Corporate Officers and Directors: Recent Developments*, 4 DEL. J. CORP. L. 690, 695 (1979) ("However, there are some cases where conceivably sequestration might be useful, for example, in situations where the defendant has some minimum contacts with Delaware and is an officer but not a director of a corporation. In such a case our director's consent statute does not apply.").

If personal jurisdiction was the officer's protection from personal liability, it was revoked in 2004. In 2004, Section 3114 was amended, in part as a response to Enron and other corporate scandals of the period. The amendment provided that persons who accept service as an officer of a Delaware corporation after January 1, 2004 are subject to Delaware jurisdiction in the same way as directors.[72] Thus, officers of Delaware corporations became subject to personal jurisdiction in Delaware courts and another piece of the puzzle of officer exposure to personal liability was put in place.

III. The Functions of Officers and Directors Differ Importantly and Their Respective Fiduciary Duties Should Reflect Such Differences

Officers and directors are often lumped together as "management" as we also have done thus far, but there are important differences between the roles of officers and directors. This Essay argues that since their respective roles differ, so too should their duties to the corporation and its stockholders differ. So long as officer fiduciary duties comport with officer functions, officer liability for the duty of care—as developed in the director context—should not apply to officers.

The distinction in roles between officers and directors arises necessarily from the structure of the corporation as outlined in the first section of this Essay. When the stockholder entrusts its capital to a corporation, it is asking implicitly for two tasks to be carried out on its behalf. First, the stockholder wants someone to dedicate attention to deliberating about the overall strategy of the firm. A multi-person deliberative body is suited to that task.[73] Second, it wants someone to ensure corporate strategies are carried out. In large organizations where specialization is a necessity, executives and employees focusing on a progressively narrower scope of responsibility are suited to that task. A deliberative body cannot effectively get things done and conversely, excessive deliberation interferes with carrying out fiat orders.[74]

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72. 74 Del. Laws 213, § 3 (2003).

73. *See* Stephen M. Bainbridge, *Why a Board? Group Decisionmaking in Corporate Governance*, 55 Vand. L. Rev. 1, 12 (2002).

74. We recognize there is some danger of overstatement. In particular, it should be noted that officers are good candidates for board service because they can knit the two functions together and ensure the deliberative body is integrated with the conceptually separate executive function of the corporation. Certain firms recently have purportedly embraced a "flatter" organizational model where a measure of deliberation is carried out by even the "enlisted" members of the firm.

One of the chief functions of a board is to deliberate.[75] Directors fulfill their duty of care in many instances by sufficiently deliberating a decision and marshalling all material information needed for the decision. While there may be deliberative elements to an officer's job, officers, in contrast, are not paid to deliberate amongst themselves, but rather to execute. Put another way, when a court analyzes whether directors fulfilled their duty of care, it asks whether the board sufficiently considered the decision before making it.[76] When a board judges the effectiveness of an officer—as for example, when hiring, firing, or rewarding executives—substance is the essence of the analysis. The board does not ask what processes an officer goes through to accomplish goals. The board's fundamental question is "Does this officer get things done?" A board of directors acts only collectively and individual directors have no inherent power to act alone to bind the corporation.[77] Officers act alone as agents and must answer singly (to the board, their superiors, or, as discussed below, the stockholders and the court) for their actions or omissions. Therefore, in holding an officer to a standard of care, a court should be mindful of the limitations of any single human mind.

A further distinction setting officers apart is that directors are expected to be beholden to no one and to exercise their independent business judgment to promote the interests of the corporation. No one can tell a director what to do.[78] Officers have a nearly opposite function. They are bound to obey—that is, to not be independent of—their board of directors and superior officers.[79] Thus, in asking whether officers have complied with a standard of care, a court should recognize that an officer has a limited range of freedom to deviate from directives.

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75. Bainbridge, *supra* note 73, at 12.

76. "The imposition of time constraints on a board's decision-making process may compromise the integrity of its deliberative process." McMullin v. Beran, 765 A.2d 910, 922 (Del. 2000).

77. *Id.*

78. "[I]t is no safe harbor to claim that one was a paid stooge for a controlling stockholder." ATR-Kim Eng Fin. Corp. v. Araneta, 2006 WL 3783520, at *21 (Del. Ch. Dec. 21, 2006).

79. Megan Wischmeier Shaner, *Restoring the Balance of Power in Corporate Management: Enforcing an Officer's Duty of Obedience*, 66 BUS. LAW. 27, 27–28 (2010).

IV. The Identical Fiduciary Duties of Directors Are Applied to Officers and a Mismatch Is Created

That officers owe fiduciary duties has been a fact of Delaware law since before the first General Corporation Law was adopted.[80] Nevertheless, the content of the fiduciary duties owed by officers was not defined until 2009. It was not until then that the Delaware Supreme Court had and took the opportunity in *Gantler v. Stephens* to hold that officers owe *the same* fiduciary duties as directors despite their different functions.

The Delaware Supreme Court was very clear in *Gantler v. Stephens* that the fiduciary duties of officers and directors are "the same." "In the past, we have implied that the officers of Delaware corporations, like directors, owe fiduciary duties of care and loyalty, and that the fiduciary duties of officers are the same as those of directors. We now explicitly so hold."[81] Even before *Gantler*, a prominent treatise on Delaware corporate law made the unqualified observation that "[w]ith respect to the obligation of officers to their own corporation and its stockholders, there is nothing in any Delaware case which suggests that the fiduciary duty owed is different in the slightest from that owed by directors."[82] The treatise now notes that because the duties are the same, "there is no need for a separate discussion of the fiduciary responsibilities of corporate officers" and cites to its treatment of director fiduciary duties.[83] In other words, in such a regime, everything a director is duty-bound to do, an officer must do also.

There is some room for interpretation in the Delaware Supreme Court's holding that the duties are "the same." A loose interpretation of that holding is that both officers and directors have fiduciary duties of care and loyalty. The two husks are thus the same, but that still leaves room for the courts to differentiate the content of the duties to particular contexts according to the different functions of directors and officers. Such an interpretation is, in substance, what we propose. But there is a stricter interpretation available as well. Under the strict interpretation, officers owe fiduciary duties of care and loyalty and the content of these duties is also the same.

80. *See supra* note 67 and accompanying text.

81. Gantler v. Stephens, 965 A.2d 695, 708–09 (Del. 2009).

82. David A. Drexler et al., 1 Delaware Corporation Law and Practice § 14.02, at 14-5 (2010); *In re* Walt Disney Co., No. Civ. A. 15452, 2004 WL 2050138, at *1, *3 (Del. Ch. Sept. 10, 2004) ("To date, the fiduciary duties of officers have been assumed to be identical to those of directors.").

83. Drexler et al., *supra* note 82.

It may be that it is the strict interpretation that flows most naturally from *Gantler*. As *Gantler* noted, Delaware law has long recognized that officers owe fiduciary duties to the corporation and its stockholders. The holding that officers owed such duties was not a novel holding of *Gantler*. Instead, *Gantler* is most naturally seen as attempting to go further and define the content of those duties as identical. Because these two interpretations of *Gantler* are still possible, there remains some likelihood that the path set out by the loose interpretation will still be taken. Indeed, there are some early indications that the Court of Chancery recognizes the inequity of imposing identical fiduciary duties on officers—particularly junior officers—as are applied to directors.[84]

V. Why the Mismatch is Harmful

Imposition of personal liability against officers for breaches of the duty of care would skew their incentives and interfere with their ability to perform by making the officer consider first how the corporate decision or action in question would affect his pocketbook. Faced with potential personal liability, the officer, instead of putting the corporate interests first, would rationally consider what he had to gain from a successful outcome (retained employment, praise, promotion) and what he had to lose from an unsuccessful outcome (potential personal liability) if he is ultimately found to have been grossly negligent. Only when assured that the decision is likely to have a net zero or positive outcome for the officer would he rationally consider whether or not the decision or mode of execution was in the best interests of the corporation. Such an incentive structure turns the concepts of fiduciary duty on their head. By imposing on officers a duty of care identical to that of directors without protection, the regime incentivizes breaches of the duty of loyalty by making the

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84. Hampshire Grp. Ltd. v. Kuttner, C.A. No. 3607-VCS, 2010 WL 2739995, at *12 (Del. Ch. July 12, 2010).

> The appropriate approach in these circumstances is to consider all the objective facts, including the relationships that subordinates have with their superiors, and to make the difficult, but necessary, judgment of whether the subordinates acted loyally by trying to do their job for proper corporate purposes in good faith, or acted disloyally by in bad faith putting the self-interest of their superior ahead of the corporation's best interest.

Id.

officer consider his own interests ahead of the corporation's interests.[85]

It has also been noted that officers have a duty of obedience to the board.[86] If officer duties really are identical to those of directors, when a board makes a decision that breaches its duty of care and directs an officer to take a particular action in furtherance of that breach, an officer would either have to breach his duty of obedience or breach his duty of care. This result is not workable. In the same way that the division of functions allows stockholders to trust directors, so must the officer be permitted to assume the good faith and care of its board absent actual knowledge of a board's breach of its duty of care.[87] The way out of this impasse and the other problems that we have highlighted (and we do not suggest that the foregoing are an exhaustive list of the quandaries) is to recognize that officers, because they have a duty to obey, arising from their functions, should be shielded from liability when acting to carry out lawful directives of the board or of their superior officers. We propose a few approaches to accomplishing that result.

VI. Suggestions for a Cure to the Mismatch

A. *Amend Section 102(b)(7)*

There is an easy cure to the problem of officer non-exculpation: exculpate officers.[88] Section 102(b)(7) should be amended to authorize corporations to exculpate officers to the same extent as currently permitted for directors. This would be an elegant solution in many ways. The amendment would be easy, clear, and unambiguous. It should not engender litigation to determine its meaning because the few interpretive kinks have been worked out of Section 102(b)(7) already. If, under *Gantler*, officers owe the same substantive fiduciary duties as directors, all of the law applicable to director exculpation could be readily retrofitted for officers. But amending Section 102(b)(7) only fixes the symptom of personal liability without addressing the root of misaligned incentives that sprouts from the imposition of identical fiduciary duties. Amending Section 102(b)(7) is like turning the music down by putting earmuffs on—reasonably

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85. Others have cogently argued that the duty of care derives from the duty of loyalty—that the duty of care is merely an application of the duty of loyalty. Thus, it would be strange for the duty of care to usurp the duty of loyalty.

86. *See* Shaner, *supra* note 79, at 28.

87. *Hampshire Grp.*, 2010 WL 2739995, at *12.

88. *See* Honabach, *supra* note 10 at 324–25.

effective but misguided. Our preferred approach is to dial down the volume by matching duties to functions.

B. *Refine Fiduciary Duty Analysis as Applied to Officers*

Delaware courts should mold the fiduciary duties of officers to suit the particular functions those officers are hired to perform. If done carefully, this would largely obviate the need for statutory exculpation. In addition, deference similar to the business judgment rule should be recognized for officers because courts are even less well-suited for evaluating officer conduct than they are for evaluating the business decisions of boards of directors. Courts should be mindful of that fact if faced with claims against officers and also bear in mind that officers already have a body whose function is to second-guess officer actions—the board of directors. The board of directors is well-placed to do this. The courts are not. Moreover, plentiful legal mechanisms are already in place for ensuring that officers remain careful, faithful, and dutiful to their corporations.

The duty of loyalty translates very well from the director context to officers. Unlike the duty of care, the court could draw heavily from director-centric fiduciary duty law when considering alleged disloyal conduct of officers. The duty of loyalty, as it has developed principally to govern director conduct, requires that the director not put his or her interests before those of the corporation.[89] Specific applications of this duty include a prohibition on appropriating corporate assets for personal use, usurping corporate opportunities, and insider trading.[90] Directors are not exculpated for such breaches and there is no reason to countenance such betrayals of trust from officers. The specific applications of the duty of loyalty relating to conflicts of interest are equally appropriate to an officer's function and help ensure alignment of incentives. There is no reason to modify this application of the duty of loyalty for officers.

The duty of care of an officer should be dramatically different from that of a director. As discussed above, officers are hired to execute. To serve their duty to the corporation as an officer, the officer should be effective in that task. Thus, because they do not carry out the functions associated with the director's duty of

89. The duty of loyalty "mandates that a director not consider of represent interests other than the best interests of the corporation and its stockholders in making a business decision." 1 R. FRANKLIN BALLOTI & JESSE A. FINKELSTEIN, THE DELAWARE LAW OF CORPORATIONS AND BUSINESS ORGANIZATIONS § 4.16, at 4-117 (3d ed. 2011 Supp.).

90. *Id.* at 4-119.

care (e.g. deliberation, information gathering, analysis), officers should not be evaluated on those metrics. Instead, they should be judged on whether they are effectively carrying out the board's (and their senior officers') directives and bringing information to the board level for consideration.[91] But judges are placed in an exceedingly poor position to evaluate the effectiveness of officers.

The business judgment rule arose from the recognition that courts are poorly placed to second-guess the business decisions of directors. Yet, it is not because judges are ignorant about the merits of board-level decisions that the law should respect board decisions. At least on the Court of Chancery, the judges have a familiarity and sophistication with business decisions faced by boards that rivals most—and exceeds many—corporate directors. If ignorance were the foundation of the business judgment rule, the best policy would be to allow the business-fluent Chancellor and Vice Chancellors to have sufficient time from case to case to learn the particulars of the board's decision so that the judge could pronounce the "right" answer. Judicial ignorance is not what makes the business judgment rule good policy.[92] The business judgment rule is good policy because second-guessing boards—even second-guessing by savvy business minds—leads to avoidance of productive risk-taking.

Judicial abstention from second-guessing is still more appropriate as it relates to officers. In comparison to their ability to evaluate director conduct, the Court of Chancery truly does lack the skillset to evaluate officer effectiveness. When evaluating director conduct, the court looks at the process employed and asks whether it was rational or, when enhanced scrutiny applies, whether it was reasonable.[93] Given its experience, the court has a very good idea of what director processes are reasonable. The court has no comparable body of knowledge with respect to how

91. *See* Shannon German, *What They Don't Know Can Hurt Them: Corporate Officers' Duty of Candor to Directors*, 34 DEL. J. CORP. L. 221, 223–24 (2009).

92. *Contra In re* Dollar Thrifty S'holder Litig., 14 A.3d 573, 602 (Del. Ch. 2010) ("Even in the realm of heightened scrutiny, judicial (law-trained) second guessing of the means chosen by such a (business-experienced) board to maximize value should, one would think, be rare.").

93. In fact, even when their observations do not result in defendant liability, Delaware judicial pronouncements have the power to influence what is perceived as corporate governance best-practices. "It is one thing for courts to establish liability standards; it is quite another for courts to set aspirational standards for corporate America. This concern has traditionally been alleviated by the fact that Delaware courts enjoy a high degree of confidence among business leaders and corporate lawyers." Jessica M. Erickson, *Overlitigating Corporate Fraud: An Empirical Examination*, 97 IOWA L. REV. 49, 97 (2011).

officers can effectively fulfill their duties. But even if the court could somehow gain the requisite knowledge, it would still be poor policy to second-guess decisions officers make and impose liability. As in the director context, second-guessing would lead to avoidance of productive risk-taking and incentivize officers to place their own interests before the corporation's.

There are veins of Delaware law that appear to provide a foundation for recognizing differentiated duties. For example, directors have a duty to be informed with respect to important corporate transactions which they are asked to consider.[94] But the duty of different directors will vary depending on the context. For example, a director who is a controlling stockholder will not be permitted (much less expected) to be informed of the corporation's bidding strategy or reserve price if the director is negotiating to buy the rest of the company.[95] The law sensibly recognizes in that situation that the director's function as a controller could interfere with his function as a director and thus, the law essentially excuses the director (and other interested directors) from participating in the decision.[96]

Beyond being poor policy on its own merits, installing the Delaware courts as arbiters of officer effectiveness would be duplicative of other legal mechanisms that operate to promote officer effectiveness and responsibility. Fundamentally, the employment relationship is where officer effectiveness should be regulated. Put simply, if officers are ineffective, they should be fired. That is a business decision appropriately entrusted to the board and made within the confines of a particular employment agreement or the principles of employment law.[97]

In other circumstances, Congress has imposed additional incentives and penalties for corporate officers, first in Sarbanes-Oxley[98] and recently under Dodd-Frank.[99] The merits of officer regulation in those laws can be fairly debated, but they are in

94. Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 367 (Del. 1993) ("The duty of the directors of a company to act on an informed basis . . . forms the duty of care element of the business judgment rule.").

95. Gesoff v. IIC Indus., Inc., 902 A.2d 1130, 1149–51 (Del. Ch. 2006).

96. There remain certain statutory formalities in which the director may participate, but the real information gathering and deliberation is usually handled by a special committee of the board.

97. If the board breaches its duties of care or loyalty in making that decision, then stockholders have appropriate recourse to the courts.

98. *See, e.g.*, Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 302, 116 Stat. 777 (codified at 15 U.S.C. § 7241 (2006) ("Corporate responsibility for financial reports")); *id.* § 304, 116 Stat. 778 (codified at 15 U.S.C.§ 7243 (2006) ("Forefeiture of certain bonuses and profits")); *id.* § 406, 116 Stat. 789 (codified at 15 U.S.C. §7264 (2006) ("Code of ethics for senior officials")).

force and fiduciary regulation from Delaware would duplicate at least a sub-set of the actions regulated under those schemes. For example, in circumstances where an officer violates the Sarbanes-Oxley obligation to review the company's financial reports, a similarly imposed fiduciary duty to act with requisite care would be needlessly duplicative.

There are drawbacks to relying solely on a refined fiduciary analysis as to officers. One of the problems is that it would take a relatively long time to settle the law and in the meantime officers remain exposed to inefficient personal liability. As a result, the best course would be to amend Section 102(b)(7) and then for the Delaware courts to begin to tailor the fiduciary duties of officers to match their functions. Without the legislative fix, the corporate governance system is only one *Van Gorkom*-esque decision away from skewing officer's incentives in an inefficient way with serious consequences to their ability to function.

C. *The Sky is Not Falling—Presently Existing Officer Protections*

Lest we be misunderstood, we do not think officers face a crisis. There are various protections available to officers that mitigate their current exposure. Corporations can indemnify officers against fees, costs, and expenses arising from lawsuits initiated against them in their capacities as officers.[100] This is an important right and goes some way toward mitigating officers' exposure, but there is an important limitation on the corporation's ability to indemnify its officers. The corporation is not permitted to indemnify officers for "judgments, fines and amounts paid in settlement" relating to derivative actions.[101] This means

99. *See* Securities Exchange Act of 1934 § 14A (codified as amended at 15 U.S.C.A. §78n-1 (2009 & Supp. 2010) ("Shareholder approval of executive compensation")).

100. DEL. CODE ANN. tit. 8, § 145 (2001).

101. *Compare id.* § 145(a):

> A corporation shall have power to indemnify any person who was or is a party or is threatened to be made a party to any threatened, pending or completed action, suit or proceeding, *whether civil, criminal, administrative or investigative (other than an action by or in the right of the corporation)* by reason of the fact that the person is or was a director, officer, employee or agent of the corporation . . . against expenses (including attorneys' fees), *judgments, fines and amounts paid in settlement* actually and reasonably incurred . . . .

(emphasis added), *with id.* § 145(b):

> A corporation shall have power to indemnify any person who was or is a party or is threatened to be made a party to any threatened, pending or completed *action or suit by or in the right of the corporation* to procure a judgment in its favor by reason of the fact that the person is or was a director, officer, employee or agent of the corporation . . .

that, if sued derivatively for violating their fiduciary duties, officers (like directors) may not be indemnified for any judgments or amounts paid in settlement. Symmetrically, officers and directors can have their legal fees and other costs paid in advance, but neither may be indemnified for judgments or amounts paid in settlement of such actions. But their respective liability exposure is not symmetrical. Directors, because of Section 102(b)(7), will never face the prospect of paying an amount in settlement personally or being personally responsible for a judgment rendered in a derivative case in which only their duty of care was at issue. Officers face a real prospect of paying to settle such cases or to pay the judgments rendered. In addition, as with directors, an officer who is ultimately unsuccessful in defending a derivative action cannot be indemnified even for his or her expenses.[102] The difference between directors and officers is that the directors have a defense available at the motion to dismiss stage that they are not liable for breaches of the duty of care.

Directors can successfully move for dismissal, without even expending the resources necessary for a trial, under circumstances where a complaint alleges only breaches of the duty of care.[103] Officers not only lack such a defense, but, if they are unsuccessful (an outcome made more likely by the unavailability of the defense), they will also be unable to have their legal expenses covered by the corporation.[104]

In addition to indemnification, corporations can purchase D&O insurance for officers and there is no current crisis in finding D&O insurance to insure officers as there was for directors in the mid-1980s. Critically, D&O insurance can cover liability where indemnification cannot.[105] It should also be remembered

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> against expenses (including attorneys' fees) actually and reasonably incurred . . . .

(emphasis added).

102. "[N]o indemnification shall be made in respect of any claim, issue or matter as to which such person shall have been adjudged to be liable to the corporation" unless otherwise provided by the Court of Chancery or other presiding court. *Id.* § 145(b).

103. Malpiede v. Townson, 780 A.2d 1075, 1092 (Del. 2001).

104. Here it is also worth noting an additional asymmetry in the DGCL that should be mended along with Section 102(b)(7). While directors can rely on reports of officers in fulfilling their fiduciary duties, Section 141(e) offers no such protection for officers themselves. The buck stops with the officers. DEL. CODE ANN. tit. 8, § 141(e) (2001).

105. *See* 1 BALOTTI & FINKELSTEIN, *supra* note 89, § 4.13[A], at 4-87 (2010 Supp.). ("D & O insurance provides additional, and in some cases broader, protection to directors as compared to indemnification . . . .").

that the frequency of officer suits has been so low historically that it was not until 2009 that the Delaware courts finally expressly held that officers owed the same fiduciary duties as directors.[106] The number may increase as a result of that holding, but it may be that officers will never be the prime targets that directors have become in fiduciary litigation.

D. *A Note on Application of Fiduciary Duties to Controlling Stockholders*

On a final note, we observe that the approach to fiduciary duties that we suggest in this Essay is equally applicable in the context of controlling stockholders. The duties that controlling stockholders owe to the corporation and the minority or unaffiliated stockholders bear very little resemblance to the fiduciary duties that directors owe. Thus, it is not surprising that while Delaware courts have tended to use the same fiduciary labels for controlling stockholders, they also have appropriately focused on restraining a controlling stockholder's ability to extract value from the minority through the corporate form, usually effected through a transaction in which the controller stands on both sides. In our view, the essence of the controller's so-called fiduciary duty of loyalty consists in not expropriating value from co-investors. In the corporate world, we call that legal restraint a duty of loyalty. In the rest of the world, people call it stealing or fraud. We submit that it ultimately confuses the issue to label a rule against stealing a "fiduciary duty," but we recognize too that the phraseology is likely here to stay. Nevertheless, courts should bear in mind the differences in function of controlling stockholders and, as in the officer context, ensure that controlling stockholder duties are not cross-pollinated from the director context.

VII. Conclusion

Officers of Delaware corporations are currently exposed to personal liability for acts done in their official capacities that are done in good faith. The duties giving rise to such liability are at odds with their role in the corporation. In order to remedy this problem, the Delaware legislature should amend Section 102(b)(7) to provide exculpation for corporate officers and the Delaware courts should begin to recognize a distinction between the duties owed by officers as compared to directors.

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106. Gantler v. Stephens, 965 A.2d 695, 708 (Del. 2009).