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THE TORT FOUNDATION OF DUTY OF CARE AND BUSINESS JUDGMENT

*Robert J. Rhee**

This Article corrects a misconception in corporation law—the belief that principles of tort law do not apply to the liability scheme of fiduciary duty. A board's duty of care implies exposure to liability, but the business judgment rule precludes it. Tort law finds fault; corporation law excuses it. The conventional wisdom says that the tort analogy fails. This dismissal of tort principles is wrong. Although shareholder derivative suits and ordinary tort cases properly yield systemically antipodal outcomes, they are bound by a common analytical framework. The principles of board liability are rooted in tort doctrines governing duty, customs, and pure economic loss. Properly applied, they produce a duty "to care" (vis-à-vis duty of care), based on good faith undertaking of care, but upon such undertaking no liability for negligently inflicted economic loss—the exact result achieved by the fiduciary duty of care and the business judgment rule. A sound tort analysis not only theorizes the enigmatic relationship between the duty of care and the business judgment rule, but it also explain Delaware's puzzling procedural-substantive divide. Fiduciary duty in corporation law rests on a tort foundation. Lastly, the thesis of this Article has a broader implication. The contractarian view of corporation law seeks to relegate the role of courts to passive custodians of the corporate contractual terms provided by the legislature and the corporation's constituents. However, this view is constrained by a tort framework wherein courts do and should play a robust, albeit reserved, role in regulating important aspects of corporate governance through continued common law process of doctrinal development of the idea of a wrong.

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INTRODUCTION

The structure of corporation law is built on two grand rules limiting the liability of participants in the corporate enterprise. The first is the rule of limited liability of shareholders.[1] The second is the rule limiting the liability of directors under the business judgment rule. Jointly these rules promote enterprise by allowing shareholders and directors to take risks without fear of catastrophic personal liability. Without them there would be no corporation as we know it. While the theory of shareholder limited liability is well understood today,[2] we still lack a consensus on the theory of the relationship between the duty of care and the business judgment rule.[3] The academic literature has instead focused on instrumental policy grounds to justify the consensus view that the business judgment rule generally produces correct outcomes. This is a curious state of academic affairs given the importance of the issue. The theoretical deficit has not been for want of scholarship, which has been voluminous.[4]

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1 *See* STEPHEN M. BAINBRIDGE, CORPORATION LAW AND ECONOMICS 126–51 (2002); ROBERT CHARLES CLARK, CORPORATE LAW 7–9 (1986); FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 40–41 (1991).

2 Although there is not a complete consensus, there are sharply defined positions. *Compare* EASTERBROOK & FISCHEL, *supra* note 1, at 41–47 (advancing a theory that limited liability is efficient), *with* Henry Hansmann & Reinier Kraakman, *Toward Unlimited Shareholder Liability for Corporate Torts*, 100 YALE L.J. 1879 (1991) (advancing a theory that limited liability is inefficient).

3 *See* BAINBRIDGE, *supra* note 1, at 242 ("[T]he lack of a coherent and unified theory explain[s] why the rule exists."); Kenneth B. Davis, Jr., *Once More, the Business Judgment Rule*, 2000 WIS. L. REV. 573, 573 ("[W]e remain short of any broad consensus . . . ."); Henry G. Manne, *Our Two Corporation Systems: Law and Economics*, 53 VA. L. REV. 259, 270 (1967) (noting that the business judgment rule is "one of the least understood concepts in the entire corporate field").

4 A sampling of works includes William T. Allen et al., *Function Over Form: A Reassessment of Standards of Review in Delaware Corporation Law*, 56 BUS. LAW. 1287 (2001) [hereinafter Allen et al., *Function Over Form*]; William T. Allen et al., *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 (2002) [hereinafter Allen et al., *Realigning*]; S. Samuel Arsht, *The Business Judgment Rule Revisited*, 8 HOFSTRA L. REV. 93 (1979); Stephen M. Bainbridge, *The Business Judgment Rule as Ahstention* [sic] *Doctrine*, 57 VAND. L. REV. 83 (2004); Margaret M. Blair & Lynn A. Stout, *Trust, Trustworthiness, and the Behavioral Foundations of Corporate Law*, 149 U. PA. L. REV. 1735, 1789–99 (2001); Dennis J. Block et al., *The Role of the Business Judgment Rule in Shareholder Litigation at the Turn of the Decade*, 45 BUS. LAW. 469 (1990); Stuart R. Cohn, *Demise of the Director's Duty of Care: Judicial Avoidance of Standards and Sanctions Through the Business Judgment Rule*, 62 TEX. L. REV. 591 (1983); Melvin Aron Eisenberg, *The Divergence of Standards of Conduct and Standards of Review in Corporate Law*, 62 FORDHAM L. REV. 437 (1993); Charles Hansen, *The Duty of Care, the Business Judgment Rule, and The American Law Institute Corporate Governance Project*, 48 BUS. LAW. 1355 (1993);

The duty of care and the business judgment rule are bound together in an enigma.[5] The mystery deepens when the tort analogy is applied. A director's duty of care is frequently analogized to the duty of care in tort law, which is the language of culpability seen in accident law.[6] "Yet, the one thing about the business judgment rule on which everyone agrees is that it insulates directors from liability for negligence."[7] Tort law finds liability; corporation law excuses it. The apparent failure of the tort analogy—the schizophrenic invocation and rejection of negligence—is jarring. Although most people agree that, generally speaking, board liability should be limited, this broad policy is intrinsically unhelpful in conceptualizing the liability boundary. The duty of care and the business judgment rule are not only important to corporation law *inter se*, but also corporation law influences the laws of other business organizations, [8] including the use of the business judgment rule.[9] Thus, the inquiry here has broad implication in the entire field of business organizations.

Lyman Johnson, *The Modest Business Judgment Rule*, 55 BUS. LAW. 625 (2000) [hereinafter Johnson, *Modest*]; Lyman Johnson, *Rethinking Judicial Review of Director Care*, 24 DEL. J. CORP. L. 787 (1999) [hereinafter Johnson, *Rethinking*]; Kenneth E. Scott, *Corporation Law and the American Law Institute Corporate Governance Project*, 35 STAN. L. REV. 927 (1983); Lynn A. Stout, *In Praise of Procedure: An Economic and Behavioral Defense of* Smith v. Van Gorkom *and the Business Judgment Rule*, 96 NW. U. L. REV. 675 (2002); E. Norman Veasey & Julie M.S. Seitz, *The Business Judgment Rule in the Revised Model Act, the* Trans Union *Case, and the ALI Project—A Strange Porridge*, 63 TEX. L. REV. 1483, 1486 (1985).

5 *See* WILLIAM T. ALLEN ET AL., COMMENTARIES AND CASES ON THE LAW OF BUSINESS ORGANIZATION 256 (2d ed. 2007) (describing the business judgment rule as a "mystery"); Blair & Stout, *supra* note 4, at 1789 (describing the lack of a theory as "one of the most persistent and puzzling problems in corporate law").

6 As of 2005, forty jurisdictions required that directors discharge their duties under a standard of care usually phrased in terms of the ordinarily prudent person under similar circumstances. ALLEN ET AL., *supra* note 5, at 243 n.7; *see* MODEL BUS. CORP. ACT § 8.30(b) (2011) ("[T]he care that a person in a like position would reasonably believe appropriate under similar circumstances."); AMERICAN LAW INSTITUTE, PRINCIPLE OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 4.01(a) (1994) ("[T]he care that an ordinarily prudent person would reasonably be expected to exercise in a like position and under similar circumstances.").

7 BAINBRIDGE, *supra* note 1, at 243; *see* Joy v. North, 692 F.2d 880, 885 (2d Cir. 1982) ("While it is often stated that corporate directors and officers will be liable for negligence in carrying out their corporate duties, all seem agreed that such a statement is misleading.").

8 The laws of limited liability companies adopt many aspects of corporate law, including provisions for exculpation, indemnification, insurance, derivative lawsuits, and special litigation committees. *See* REVISED UNIFORM LIMITED LIABILITY COMPANY ACT §§ 110(d), 408, 902, 905 (2006).

9 *See id.* § 409(c); IDAHO UNIFORM LIMITED LIABILITY COMPANY ACT § 30-6-409(3).

This Article provides a theory of the duty of care and the business judgment rule through the prism of tort theory and principles.[10] To be clear, I do not argue that a breach of fiduciary duty is a tort,[11] just the way it is not a breach of contract, notwithstanding the contractarian view of corporate governance. The thesis here is that the liability scheme of corporate boards under the doctrines of fiduciary duty and the business judgment rule can be understood through the analytics of torts.[12] Although corporate law scholars have been wary of inter-doctrinal analysis of corporation law,[13] tort principles are embedded in important doctrines of corporation law.[14] In the arena of board liability for wrongful conduct, an inter-doctrinal analysis is inevitable.[15] When corporation law states that a director should act as an "ordinarily careful and prudent" person[16] and a breach of the duty of care is defined as "gross negligence,"[17] it borrows from the lexicon of torts and scholarship should squarely address, and not casually dismiss, this tension.

This Article answers the question: *If there was no corporation law of fiduciary duty of care and tort law applied instead, what would the legal framework of a director's duty and standard of liability look like?*[18] Few scholars

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10 This Article concerns the duty of care. Outside of the good faith jurisprudence of the duty of loyalty, see *Stone v. Ritter*, 911 A.2d 362 (Del. 2006), the traditional duty of loyalty is fairly uncontroversial as to basic principles.

11 *See* Marcel Kahan & Edward B. Rock, *When the Government Is the Controlling Shareholder*, 89 TEX. L. REV. 1293, 1327 (2011) ("As a conceptual matter, it is also pretty clear that breaches of fiduciary duties are not torts, at least not in the common law use of that term, although they may be 'civil wrongs.' ").

12 Common law jurisdictions outside of the United States have recognized that tort law provides an analytical foundation for a director's duty of care. *See* John H. Farrar, *Directors' Duties of Care*, 23 SINGAPORE ACAD. L.J. 745, 747–50, 752–54 (2011).

13 *See* Robert J. Rhee, *Bonding Limited Liability*, 51 WM. & MARY L. REV. 1417, 1441 (2010) (noting that "corporate law scholarship has eschewed an extradoctrinal analysis"); Edward Rock & Michael Wachter, *Dangerous Liaisons: Corporate Law, Trust Law, and Interdoctrinal Legal Transplants*, 96 NW. U. L. REV. 651, 651–52 (2002) (arguing that transplanting the law of trusts and agency into corporate law created "mischief").

14 *See infra* Part IV.A.

15 *Cf.* Rhee, *supra* note 13, at 1441–42 (criticizing the aversion to interdoctrinal analysis in corporate law). Some scholars have recognized the intersection of tort and corporation laws. *See* Martin Petrin, *The Curious Case of Directors' and Officers' Liability for Supervision and Management: Exploring the Intersection of Corporate and Tort Law*, 59 AM. U. L. REV. 1661, 1665 (2010) (proposing a tort-based approach for imposing liability on officers and directors in cases of fraud and intentional misconduct).

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

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

18 This question is not just a theoretical exercise. In presiding over *Barnes v. Andrews*, 298 F. 614 (S.D.N.Y. 1924), a case brought by the receiver against a director for the collapse of a corporation due to the director's neglect and inattention, Judge

have engaged in this analysis,[19] presumably because most have assumed that the application of tort law to corporate decisions would expand board liability under the general negligence standard to untenable levels. This conventional wisdom is wrong. Tort theory provides not just the lexicon of liability, but the foundational principles of the duty and liability of corporate boards.

Under a correct account of the tort analogy, the duty of care and the business judgment rule are not antipodes of a paradox, but are complementary principles governing duty and its scope. Two principles play key roles. First, an affirmative undertaking to manage the affairs of the corporation[20] not only begets a fiduciary duty of care, but it limits the scope of that duty. Under the tort doctrine of industry customs, the scope of a director's duty of care reflects the implied standard of care that would be adopted by market participants. A tort-based proposition is consistent with the prevailing contractarian theory of corporation law, and it shows that the negligence standard would not apply to the substance of business decisions. Second, theories of pure economic loss provide the foundation principles for the rule that a director's duty of care does not encompass negligently inflicted economic loss. Microeconomic analysis has shown that mistakes in market transactions often result in no social cost, thus justifying a rule of no liability.[21] At a broader political economic level, the precondition of a market economy, one based on profit and risk taking, is uncertainty and imperfect information. This broader analysis has shown that courts refrain from interfering with market outcomes through the rule of no duty.[22] These limitations of duty under tort law explain the principles of the duty of care and the business judgment rule.

This Article argues that the board's duty *of* care is a mischievous misnomer of preposition. This lexicon invokes the general negli-

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Learned Hand framed the issue of director liability this way: "This cause of action rests upon a tort, as much though it be a tort of omission as though it had rested upon a positive act." *Id.* at 616.

19 *Cf.* Robert B. Thompson, *Federal Corporate Law: Torts and Fiduciary Duty*, 31 J. CORP. L. 877, 891 (2006) (arguing that federal securities laws regulating corporate governance are based on a tort foundation).

20 *See* DEL. CODE ANN. tit. 8, § 141(a); MODEL BUS. CORP. ACT § 8.01(b) (2011).

21 *See, e.g.*, W. Bishop, *Economic Loss in Tort*, 2 OXFORD J. LEGAL STUD. 1, 1 (1982) ("[M]any financial losses may not be losses at all in an economic sense, that is from the point of view of net social welfare.").

22 *See, e.g.*, Robert J. Rhee, *A Production Theory of Pure Economic Loss*, 104 NW. U. L. REV. 49, 90 (2010) ("The pure economic loss rule is a market abstention doctrine. Courts do not interfere with market outcomes by redistributing wealth upon adverse outcome causally traced to a specific form of business risk.").

gence principle requiring an examination of the substance of the action when in fact tort law does not extend the scope of duty and liability that far. Tort theory limits the scope of a board's legal obligation to a duty *to* care for the corporation, which embodies the duty of good faith intention evinced by effort toward the care and custody of the corporation and the exercise of authority vested in a board whose members affirmatively assume the mantle of directorship.[23] The duty of care imposes an affirmative duty, and the business judgment rule defines the scope of that duty implied in the customary terms of a voluntary undertaking.

This Article theorizes the enigmatic relationship between the duty of care and the business judgment rule. The principles of torts can and do play a robust part in regulating important aspects of the internal affairs of the corporation. In the tort framework, there are several narrow theories under which directors can be held accountable: (1) indifference to caring evinced by a failure to monitor or manage the affairs of the corporation or an abdication of the mantle of responsibility;[24] (2) insufficient effort to care for the corporation evinced by substantial procedural defects in decision-making;[25] and (3) bad faith evinced by a knowing dereliction of duty.[26] These theories of board liability are well recognized, and the common thread is a breach of a director's affirmative duty to undertake care of the corporation. A corrected tort analogy provides theoretical coherence to the liability scheme. It explains corporation law's focus on demonstrable acts of care evincing good faith and benign intentions of a custodian as opposed to an examination of the substantive actions causing eco-

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23 Indeed, the recent proliferation of scholarship on good faith is consistent with the view. *See* Stephen M. Bainbridge et al., *The Convergence of Good Faith and Oversight*, 55 UCLA L. REV. 559 (2008); Melvin A. Eisenberg, *The Duty of Good Faith in Corporate Law*, 31 DEL. J. CORP. L. 1 (2006); Sean J. Griffith, *Good Faith Business Judgment: A Theory of Rhetoric in Corporate Law Jurisprudence*, 55 DUKE L.J. 1 (2005); Hillary A. Sale, *Monitoring* Caremark*'s Good Faith*, 32 DEL. J. CORP. L. 719 (2007); Leo E. Strine, Jr. et al., *Loyalty's Core Demand: The Defining Role of Good Faith in Corporation Law*, 98 GEO. L.J. 629 (2010).

24 *See, e.g.*, Stone v. Ritter, 911 A.2d 362, 364–65 (Del. 2006); Francis v. United Jersey Bank, 432 A.2d 814, 822 (N.J. 1981); MODEL BUS. CORP. ACT § 8.31(a)(2)(iv) (2011); *see also* Grimes v. Donald, 673 A.2d 1207, 1210 (Del. 1996) (ruling that an abdication of duty may be the basis of a direct claims by shareholders), *overruled on other grounds by* Brehm v. Eisner, 746 A.2d 244 (Del. 2000).

25 *See, e.g.*, Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985); Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 367 (Del. 1993); MODEL BUS. CORP. ACT § 8.31(a)(2)(ii)(B) (2011).

26 *See In re* Walt Disney Co. Derivative Litig., 906 A.2d 27, 64, 66–67 (Del. 2006); MODEL BUS. CORP. ACT § 8.31(a)(2)(i) (2011).

nomic loss, and Delaware's puzzling substantive-procedural divide wherein duty of care is limited to procedural aspects of decision-making.

Lastly, this Article shows that there is a distinct space in corporate law for a tort-based theory of fiduciary duty, the obligation of good faith, and the liability of directors. The contractarian view of corporate law emphasizes the privateness of contracts, and it diminishes the role and power of courts in the realm of corporate governance and board liability. In contrast, the tort framework of fiduciary duty justifies a robust, albeit reserved, role of courts in regulating corporate governance through the common law development of law. When courts refrain from unreasonably interfering in corporate governance, they are expressing an important normative value of the relationship between private decisionmaking and public review.

This Article is written in four parts. Part I frames the issues by summarizing the duty of care and the business judgment rule, and then explaining the apparent failure of the "tort analogy." Part II shows the tort foundation of the duty of care and the business judgment. When principles of duty, industry customs, and pure economic loss are properly applied, a board has a duty of care arising from its affirmative undertaking of managerial power, but the scope of duty is limited by the customary understanding under a contract analysis. Part III develops a broader economic perspective. The doctrine and theory of pure economic loss in tort law explain why a board has no negligence-based duty to prevent a corporation's economic loss. Part IV discusses the larger implications of the tort foundation of duty and business judgment. It argues that courts do and should play a robust and authoritative role, albeit reserved, in regulating important aspects of the internal affairs of the corporation through continued doctrinal development of the idea of a wrong.

I. Duty, Business Judgment, and the Tort Analogy

A. *Fiduciary Duty and Business Judgment*

The duty of care has been a feature of organizational law since the precursors of the modern corporation.[27] Analogous to a common obligation under tort law, "directors of a corporation in managing the corporate affairs are bound to use that amount of care which ordina-

27 *See* Charitable Corp. v. Sutton, 26 Eng. Rep. 642, 645 (Ch. 1742) (holding that "[b]y accepting of a trust of this sort, a person is obliged to execute it with fidelity and reasonable diligence; and it is no excuse to say that they had no benefit from it"); *see also* Marcia M. McMurray, Note, *An Historical Perspective on the Duty of Care, the Duty of Loyalty, and the Business Judgment Rule*, 40 Vand. L. Rev. 605, 606–13 (1987).

rily careful and prudent men would use in similar circumstances."[28] Failure to conform to this standard implies the real possibility of liability for negligence, though findings of culpability are in fact infrequent (and impositions of personal liability even rarer[29]).

The textbook case on the duty of care is the most famous corporate law case of all: *Smith v. Van Gorkom*.[30] There, the board of the target company engaged in a flawed process when it approved a merger agreement within a constrained time period without adequate evaluation of the merger consideration, without reading the merger agreement, and without adequate understanding of the negotiation between the chief executive officer and the acquirer that resulted in the proposal for a takeover.[31] The court ruled that the appropriate standard of review was gross negligence.[32] It held that the board's flawed procedure met this standard. This was the first time that the Delaware Supreme Court found a set of facts constituting a breach of the duty of care in connection with the exercise of a business judgment,[33] prompting shocked reactions from the corporate bar and legal scholars.[34]

Several years after *Van Gorkom*, the Delaware Supreme Court again ruled in favor of liability for a breach of the duty of care in *Cede & Co. v. Technicolor, Inc.*[35] The facts were similar to those in *Van Gorkom*: the board was minimally informed; the transaction was driven almost exclusively by Technicolor's CEO; and the board rubber-stamped the process.[36] The chancery court, per Chancellor William Allen, expressed "grave doubts" that the board satisfied the *Van*

28 Graham v. Allis-Chalmers Mfg. Co., 188 A.2d 125, 130 (Del. 1963); *see* MODEL BUS. CORP. ACT § 8.30 (2011).

29 Among other things, the articles of incorporation may include exculpation, indemnification, and insurance provisions, which collectively shield a director's personal liability. *See* DEL. CODE ANN. tit. 8, §§ 102(b)(7), 145(a), 145(g).

30 *Van Gorkom*, 488 A.2d.

31 *Id.* at 875.

32 *Id.* at 873.

33 ALLEN ET AL., *supra* note 5, at 258; Rock & Wachter, *supra* note 13, at 651; *see* Joseph W. Bishop, Jr., *Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers*, 77 YALE L.J. 1078, 1099 (1968) (noting "a search for a very small number of needles in a very large haystack").

34 *See* Daniel R. Fischel, *The Business Judgment Rule and the* Trans Union *Case*, 40 BUS. LAW. 1437, 1455 (1985); Jonathan R. Macey & Geoffrey P. Miller, Comment, Trans Union *Reconsidered*, 98 YALE L.J. 127 (1988); Rock & Wachter, *supra* note 13, at 651.

35 *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345 (Del. 1993).

36 *Id.* at 352–57.

Gorkom standard.[37] The supreme court deferred to the trial court's finding of "pervasive and persuasive evidence" of a violation of the duty of care,[38] and ruled that in the face of a finding of a breach of duty of care the trial court must apply the entire fairness review to the transaction where the burden is on the defendant to prove fair dealing and fair price.[39] With respect to the business judgment rule, the court opined that the rule "operates to preclude a court from imposing itself *unreasonably* on the business and affairs of a corporation."[40]

In both *Van Gorkom* and *Cede*, the business judgment rule did not protect the board because there was a finding that the board breached its duty of care. The breach of duty arose from substantial procedural defects. In Delaware, the duty of care is limited by a substantive-procedural dichotomy, which was made explicit in *Brehm v. Eisner*[41]:

> As for the plaintiffs' contention that the directors failed to exercise "substantive due care," we should note that such a concept is foreign to the business judgment rule. Courts do not measure, weigh or quantify directors' judgments. We do not even decide if they are reasonable in this context. Due care in the decisionmaking context is *process* due care only.[42]

Thus, the scope of the duty of care is limited to the process of decision-making, and not the substantive quality of the business decision.[43]

The duty of care and the business judgment rule are closely related.[44] Like the duty of care, the business judgment rule traces its

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37 Cinerama, Inc. v. Technicolor, Inc., 17 DEL. J. CORP. L. 551, 560 (1992), *available at* 1991 WL 111134 (Del. Ch. June 24, 1991), *rev'd Cede*, 634 A.2d.

38 *Cede*, 634 A.2d at 350, 358, 373.

39 *Id.* at 361; *see* McMullin v. Beran, 765 A.2d 910, 916–17 (Del. 2000) (reaffirming the *Cede* framework).

40 *Cede*, 634 A.2d at 360 (emphasis added).

41 Brehm v. Eisner, 746 A.2d 244 (Del. 2000).

42 *Id.* at 264. A line of Delaware cases have stated that a court should not substitute its judgment for the board's on substantive business decisions. *See* Citron v. Fairchild Camera & Instrument Corp., 569 A.2d 53, 66 (Del. 1989); Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954 (Del. 1985); Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971); *In re* Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 967 (Del. Ch. 1996).

43 Bainbridge, *supra* note 4, at 92; Hansen, *supra* note 4, at 1356; Stout, *supra* note 4, at 675; Veasey & Seitz, *supra* note 4, at 1486.

44 *See* Bainbridge, *supra* note 4, at 88 (stating the business judgment rule is "intimately associated" with the duty of care); Douglas M. Branson, *Intracorporate Process and the Avoidance of Director Liability*, 24 WAKE FOREST L. REV. 97, 97 (1989) (noting that the business judgment rule is a "corollary" to the duty of care).

roots back to the rise of the early corporations.[45] It is a judge-made rule developed through the common law process,[46] and it is based on the judicial recognition of the board's statutory authority to manage a corporation.[47] A modern formulation of the business judgment rule, as articulated in *Aronson v. Lewis*,[48] provides that the rule "is a presumption that in making a business decision the directors . . . 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."[49]

The business judgment rule is applied if these conditions are satisfied: (1) a decision was made upon an informed decision-making process; and (2) it was made in good faith and not tainted by self-interest.[50] The first condition addresses whether the board satisfied the duty of care, and the second condition addresses the duty of loyalty.[51] Unless a plaintiff can show a breach of fiduciary duty, the business judgment rule shields directors from judicial scrutiny of the substantive decision, even if it is patently wrong.

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45 *See* Godbold v. Branch Bank at Mobile, 11 Ala. 191, 199 (1847); Bodell v. General Gas & Elec. Corp., 140 A. 264, 268 (Del. 1927); Percy v. Millaudon, 8 Mart. (n.s.) 68, 77–78 (La. 1829); Pollitz v. Wabash R.R. Co., 100 N.E. 721, 724 (N.Y. 1912); *see also* McMurray, *supra* note 27, at 613 ("The business judgment rule developed concurrently with the duty of care.").

46 Zapata Corp. v. Maldonado, 430 A.2d 779, 782 (Del. 1981); Douglas M. Branson, *The Rule that Isn't a Rule—The Business Judgment Rule*, 36 VAL. U. L. REV. 631, 633 (2002).

47 Omnicare, Inc. v. NCS Healthcare, Inc., 818 A.2d 914, 927 (Del. 2003); Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 360 (Del. 1993).

48 Aronson v. Lewis, 473 A.2d 805 (Del. 1984).

49 *Id.* at 812.

50 Eisenberg, *supra* note 4, at 441. These conditions boil down to two essential questions. "First, did the Board reach its decision in the good faith pursuit of a legitimate corporate interest? Second, did the Board do so advisedly?" Gantler v. Stephens, 965 A.2d 695, 706 (Del. 2009).

51 The business judgment rule does not apply when there has been no exercise of judgment resulting in a decision. *See In re* Walt Disney Co. Derivative Litig., 907 A.2d 693, 748 (Del. Ch. 2005), *aff'd*, 906 A.2d 27 (Del. 2006) (en banc); Gimbel v. Signal Cos., 316 A.2d 599, 609 (Del. Ch. 1974). Intentional omissions, being decisions, are protected. *See Aronson*, 473 A.2d at 813. But neglectful inaction is not protected. *See, e.g.*, Francis v. United Jersey Bank, 432 A.2d 814 (N.J. 1981). Another caveat is that the decision must meet a minimum standard of rationality. *See* Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971); Gagliardi v. Trifoods Int'l, Inc., 683 A.2d 1049, 1051–52 (Del. Ch. 1996). Irrationality is "the outer limit of the business judgment rule" and "the functional equivalent of the waste test." Brehm v. Eisner, 746 A.2d 244, 264 (Del. 2000). Waste occurs "only in the rare, 'unconscionable case'" where a board irrationally squanders corporate assets. *In re* Walt Disney Co. Derivative Litig., 906 A.2d 27, 74 (Del. 2006). As such, the exception has been described as "theoretical." *Gagliardi*, 683 A.2d at 1051–52.

A well-known example of the business judgment rule at work is *Kamin v. American Express Co.*[52] There, American Express had bought a stake in an investment bank, which subsequently declined in value. The board decided to divest, and it had two choices: sell the stake, or distribute the asset to shareholders through a special in-kind dividend. A sale would have resulted in recognizing a $25 million loss on the income statement, which would have yielded about $8 million of tax savings due to the reduction in taxable income. A distribution of shares would have avoided the loss recognition, but would have forfeited the tax advantage. The choice was between increasing accounting profit at the cost of reducing true economic value, and increasing economic value by recognizing an incurred loss under accounting rules. This is no choice at all. Since firm value is the sum of the present value of the firm's free cash flow,[53] a sale that would have reduced the accounting profit was the correct choice as a matter of finance theory.

The board made the wrong decision and issued the special dividend, though the decision-making process was informed as a matter of procedure. The board considered both options, but believed that a reduction in reported income would lower share price. This explanation is not as irrational as a coin flip, but it has no basis in generally accepted, widely known theory of valuation. Share price is not the same as intrinsic value.[54] Share price boosted by accounting profit alone does not increase the value of the firm, as evinced by the collapse of Enron. With a well-functioning capital market, the decline is the asset value would have already been incorporated into American Express's share price.[55] The board's choice was to take $8 million of cash on the table or nothing at all. Its decision to take nothing was indefensible error.[56] One would be hard pressed to find an

52 Kamin v. American Express Co, 383 N.Y.S.2d 807 (1976), *aff'd*, 387 N.Y.S.2d 993 (App. Div. 1976).

53 Richard A. Brealey et al., Principles of Corporate Finance 90–93 (10th ed. 2011).

54 Fischer Black, *Noise*, 41 J. Fin. 529, 532 (1986).

55 The *Kamin* court understood this point well when it noted that the dispute concerned "the best way to handle a loss already incurred on an investment." *Kamin*, 383 N.Y.S.2d at 812.

56 Although the decision was clearly wrong, the board's action may not have been irrational from the perspective of a self-interested agent. It can be explained by improper but unprovable motives such as a vain attempt to support short-term stock prices for the purpose of executive compensation, or obfuscating the nature of a failed investment which would have been made clearer with the recognition of a loss. Thus, *Kamin* can be seen as an unprovable duty of loyalty case that had to be brought as a duty of care case.

economist or a law professor who would defend the decision in *Kamin*.[57]

In spite of the demonstrably wrong decision, the court properly dismissed the plaintiff's complaint per the application of the business judgment rule.[58] Since the board was reasonably informed and engaged in a proper process, care was given; the board's mistake "presents no basis for the superimposition of judicial judgment, so long as it appears that the directors have been acting in good faith."[59] Once applied, the business judgment rule precludes a substantive review of a board's action, irrespective of the correctness or the intelligence of a decision. The business judgment rule is striking in that not only does it protect risky decisions, but as courts and scholars cheerfully (and correctly) tell us it also protects foolish, awful, and egregious decisions,[60] whereas tort law would never countenance the stupid person defense.[61]

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57 *See, e.g.*, Bainbridge, *supra* note 4, at 98 ("[I]t seems indisputable that American Express' board made the wrong decision.").

58 "Whatever the terminology, the fact is that liability is rarely imposed upon corporate directors or officers simply for bad judgment and this reluctance to impose liability for unsuccessful business decisions has been doctrinally labelled [sic] the business judgment rule." Joy v. North, 692 F.2d 880, 885 (2d Cir. 1982).

59 *Kamin*, 383 N.Y.S.2d at 812*; accord* Strassburger v. Earley, 752 A.2d 557, 582 (Del. Ch. 2000) ("The business judgment rule shields directors form liability for good faith business decisions, even those that turn out to be mistaken.").

60 *See, e.g.*, *In re* Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 967 (Del. Ch. 1996) ("[W]hether a judge or jury considering the matter after the fact, believes a decision substantively wrong, or degrees of wrong extending through 'stupid' to 'egregious' or 'irrational,' provides no ground for director liability, so long as the court determines that the process employed was either rational or employed in a *good faith* effort to advance corporate interests."); Gagliardi v. TriFoods Int'l, Inc., 683 A.2d 1049, 1052 (Del. Ch. 1996) ("If, however, corporate directors were to be found liable for a corporate loss from a risky project on the ground that the investment was too risky (foolishly risky! stupidly risky! egregiously risky!—you supply the adverb), their liability would be joint and several for the whole loss . . . ."); ALLEN ET AL., *supra* note 5, at 255 ("[D]isinterested directors who act deliberately and in good faith should never be liable for a resulting loss, no matter how stupid their decisions may seem ex post."); EASTERBROOK & FISCHEL, *supra* note 1, at 98 ("Occasionally the decision will be a howler, making inquiry easy."); Edward B. Rock & Michael L. Wachter, *Islands of Conscious Power: Law, Norms, and the Self-Governing Corporation*, 149 U. PA. L. REV. 1619, 1672 (2001) (suggesting that directors will not be liable for "pretty dumb" decisions); Stout, *supra* note 4, at 676 ("[I]t shields directors who follow the requisite procedures from liability even when they make reckless, foolish, and downright stupid decisions."); Veasey & Seitz, *supra* note 4, at 1486 (noting "[i]n cases other than those involving contests for control or termination of derivatives suits," courts are unlikely to impose liability on decisions "no matter how ill-advised, stupid, or questionable").

61 The stupid-person defense has long been rejected in common law. *See, e.g.*, Vaughn v. Menlove, 132 Eng. Rep. 490, 492 (1837) (rejecting the defense in a negli-

B. *Critique of Two Rationales for the Business Judgment Rule*

The business judgment rule has been justified on many policy grounds. As I show in Parts II and III, *infra*, several of these rationales are sound instrumental reasons that justify the rule, and I further show that these reasons are the policy percolations of a theory based on a tort foundation. For completeness of analysis, two frequently cited and widely supported rationales are discussed below. I conclude that these two rationales are problematic on their own terms.

One argument for the business judgment rule is the claim that courts are incompetent to review business decisions. Courts and commentators have suggested that the complexity of business is beyond the intellectual reach of courts.[62] Construed strictly, this argument is at best not a serious thought, and at worst a disingenuous assertion. It elevates the business profession to some rarefied level of incomprehensibility, and as such courts could not presume to venture a review of board decisions.[63] The truth is that many business decisions are subject to rational judicial assessment. One need not be an officer or director to understand that the world is uncertain, profit is not guaranteed, and risks must be taken. Even a child knows the risks of run-

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gence action that the defendant "ought not to be responsible for the misfortune of not possessing the highest order of intelligence").

62 *See, e.g.*, Shlensky v. Wrigley, 237 N.E.2d 776, 780 (Ill. App. Ct. 1968) ("[W]e do not mean to say that we have decided that the decision of the directors was a correct one. That is beyond our jurisdiction and ability."); Dodge v. Ford Motor Co., 170 N.W. 668, 684 (Mich. 1919) ("The judges are not business experts."); Auerbach v. Bennett, 393 N.E.2d 994, 1000 (N.Y. 1979) ("[C]ourts are ill equipped and infrequently called on to evaluate what are and must be essentially business judgments."); *see also* Dennis J. Block et al., *The Role of the Business Judgment Rule in Shareholder Litigation at the Turn of the Decade*, 45 BUS. LAW. 469, 490 (1990) ("[Courts] are admittedly ill-equipped to handle [complex corporate decision-making]."); Robert J. Haft, *Business Decisions by the New Board: Behavioral Science and Corporate Law*, 80 MICH. L. REV. 1, 15 (1981) ("[J]udges and juries [ ] lack competence to evaluate complex business decisions . . . ."); Veasey & Seitz, *supra* note 4, at 1485 ("[A] court is ill-equipped to make business decisions . . . .").

63 Most CEOs of major public companies do not have graduate degrees, and some lack even undergraduate degrees. *See* Menachem Wecker, *Where the Fortune 500 CEOs Went to College* (May 14, 2012), *available at* http://www.usnews.com/education/best-graduate-schools/top-business-schools/articles/2012/05/14/where-the-fortune-500-ceos-went-to-school ("[T]he Fortune 500 executives who completed both college and graduate school collectively earned about 200 MBAs and about 140 other graduate degrees."). Nearly 160 CEOs in the Fortune 500 companies have no graduate degree, and 35 have no college degree. *Id.* The suggestion here is not that one needs a graduate degree to run public companies, or that running a public company is easy, but that glorification of people and positions and exaggeration of complexity are unwarranted.

ning a lemonade stand. In fact, courts routinely review business decisions under the entire fairness standard upon a plaintiff's rebuttal of the business judgment rule, at which point the court engages in a substantive review of the business decision and must be satisfied of its fairness.[64]

If courts are competent to understand the economics of antitrust, the etiology of diseases, the economic effects of healthcare legislation, or complex business decisionmaking in the context of assigning tort liability, they are capable of understanding and passing judgment on business decisions, complexity notwithstanding.[65] If courts need help, expert witnesses in all aspects of business management are plentiful. All of the epistemological and psychological problems associated with discovering the truth of a past occurrence are no more difficult in corporation law than in other fields of law. Despite frequent assertions, scholars have been rightfully skeptical of the argument that courts lack the technical competence to review business decisions.[66]

Another frequently cited rationale for the business judgment rule is the explanation that the standard of conduct and the standard of review diverge in corporation law.[67] The standard of conduct expressed in the duty of care is an aspirational norm providing boards guidance on how they should manage the corporation,[68] whereas the

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64 "Under the entire fairness standard of judicial review, the defendant directors must establish to the *court's* satisfaction that the transaction was the product of both fair dealing *and* fair price." Cede & Co. v. Techicolor, Inc., 634 A.2d 345, 361 (Del. 1993); *see* Allen et al., *Realigning*, *supra* note 4, at 461 (noting that substantive review under the entire fairness standard is proper in loyalty violation). Commentators have suggested that, in truth, courts do review the substance of business decisions. *See* Bainbridge, *supra* note 4, at 91; Eisenberg, *supra* note 4, at 442; William T. Quillen, *Trans Union, Business Judgment, and Neutral Principles*, 10 DEL. J. CORP. L. 465, 492 (1985); David Rosenberg, *Galactic Stupidity and the Business Judgment Rule*, 32 J. CORP. L. 301, 301–302 (2007) ("It is a truth almost universally acknowledged that courts will not review the substance of the business decisions of corporate directors except under extraordinary circumstances.").

65 *See* BAINBRIDGE, *supra* note 1, at 254 ("Reviewing a baseball team's board of directors' refusal to play games at night, for example, seems no more technically demanding than reviewing medical or product design decisions.").

66 *See id.* at 257 (noting that the technical complexity of tort problems may be equivalent to that of business decisions); EASTERBROOK & FISCHEL, *supra* note 1, at 94 ("The business judgment rule must rest on something more [than judicial incompetence]."); R. Franklin Balotti & James J. Hanks, Jr., *Rejudging the Business Judgment Rule*, 48 BUS. LAW. 1337, 1341–42 (1993) (same).

67 *See* Eisenberg, *supra* note 4, at 437.

68 *Id.* at 437, 464. However, this scheme is not meaningless, it is argued, because it still influences behavior. *Id.* at 464; *see* ALLEN ET AL., *supra* note 5, at 257 ("[A]rticulating the standard of care has the pedagogic function of informing them just what 'doing the right thing' means under the circumstances.").

standard of review expressed in the business judgment rule is the legal rule providing courts the legal standard to assess liability.[69] In other fields of law such as tort law, the standards of conduct and review conflate to a single standard for the purpose of judicial review.[70] In corporation law, the two standards are said to diverge due to the "institutional nature of the corporation."[71] Directors frequently make decisions with incomplete information, and "on the basis of bounded rationality."[72] Merging the standard of conduct with the standard of review, it is said, would impose greater cost.[73] Thus, the explanation of divergent standards answers Robert Clark's question—"Is the duty of care simply gobbledygook, then, or a mere exhortation rather than an enforceable legal duty?"[74]—with a resounding "yes." This idea has been influential and endorsed by prominent scholars and judges.[75] It has been incorporated into the Model Business Corporation Act.[76]

Despite its prominence and the acceptance of the theory by prominent portions of the academic community, the idea of divergent standards is puzzling from the standpoint of explaining the role of courts and the concept of liability for wrongs.[77] No one can deny that the fundamental role of courts is to apply rules of law, determine wrongs, and assign liability. Yet, the theory of divergent standards says that courts are ultimately cheerleaders for the aspiration of "best practices." Given that many academics, think tanks, business roundtables,

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69 Eisenberg, *supra* note 4, at 462.

70 *Id.* at 437, 463.

71 *Id.* at 464.

72 *Id.* at 466.

73 *Id.* at 467–68.

74 CLARK, *supra* note 1, at 124.

75 *See* ALLEN ET AL., *supra* note 5, at 257 (noting that "there is social value to announcing a standard ('you must act as a reasonable person would act') that is not enforced with a liability rule"); Allen et al., *Function Over Form*, *supra* note 4, at 1295–96; Allen et al., *Realigning*, *supra* note 4, at 450.

76 Section 8.30, titled "Standards of Conduct for Directors," provides that when discharging the duties of a director, she shall act in a manner she reasonably believes to be in the best interest of the corporation and discharge oversight duties with the care that a person would reasonably believe appropriate under similar circumstances. *See* MODEL BUS. CORP. ACT § 8.30(a)–(b) (2011). But Section 8.31, titled "Standards of Liability for Directors," provides that absent a showing of bad faith, derogation of duty, or unreasonable belief, there shall be no liability "for any decision to take or not to take action, or any failure to take any action." *Id.* § 8.31(a). The comments to the MBCA make clear that this approach relies on Eisenberg's thesis of the divergence between the standard of conduct and the standard of review. *Id.* official cmt.

77 *See* D. Gordon Smith, *A Proposal to Eliminate Director Standards from the Model Business Corporation Act*, 67 U. CIN. L. REV. 1201, 1202 (1999) (critiquing the divergent standards explanation).

and pundits contribute to this enterprise, it is unclear what additional value is to be gained from the elocution of courts through essentially advisory opinions. The ultimate source of the expressive value of judicial opinions is derived solely from the power to assess liability (*i.e.*, a consultant in a black robe is still just a consultant). In other fields of law in which disputes are adjudicated with the outcome at stake, courts are special precisely because they can prescribe and enforce laws. This is not to say that, generally speaking, norms are unimportant to corporate governance,[78] and courts may even have a role in opining per dicta and appropriate tangents on the ideals of corporate governance and business management,[79] but the term "fiduciary duty" has special legal meaning, which is a legally binding obligation. The determination of liability for breach of duty is a legal question.[80] The exhortation that directors ought to act reasonably is unhelpful, not because it is wrong, but because it is trite. How else should directors behave? Do they really need judges to remind them that they ought to behave reasonably under the circumstances? If the average motorist of ordinary intelligence, even without the benefit of legal advice, knows that she must act reasonably on the road, one suspects that the average director, typically a highly accomplished and high standing member of our society, would know society's expectation as well. The dichotomy of standards essentially says that a director's "fiduciary duty" is not a legal obligation backed by the force of law. It trivializes the role of courts and laws, and thus attempts to justify academically their excision from decisional matters of corporate governance.

Liability for a wrong should ultimately matter, a point amply demonstrated by the shocked reaction to the finding of liability in *Smith v. Van Gorkom*.[81] A mountain of papers on aspiration does not hold a candle to a single-page order of judgment. Directors do not need aspirational sermons on the boardroom mount,[82] when we consider that it comes with the price tag of Wall Street investment banks and law firms who must divine what the sermons actually mean, a sig-

78 *Cf.* Melvin A. Eisenberg, *Corporate Law and Social Norms*, 99 COLUM. L. REV. 1253 (1999) (describing the operation of social norms—behavior, practices, and obligation—in motivating adherence to corporate law); Rock & Wachter, *supra* note 60, at 1640–53.

79 *See In re* Walt Disney Co. Derivative Litig., 906 A.2d 27, 56 (Del. 2006) (opining on the "best practices" of corporate executive compensation process).

80 Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 360 (Del. 1993).

81 *See supra* note 34 (describing the criticism).

82 *But see* Edward B. Rock, *Saints and Sinners: How Does Delaware Corporate Law Work?*, 44 UCLA L. REV. 1009, 1016 (1997) (arguing that judicial opinions "can best be thought of as 'corporate law sermons'" and that judges are "preachers").

nificant cost attached to every meaningful transaction. Directors are typically highly accomplished, ambitious, sophisticated, and well advised; they know full well that they ought to act reasonably without reminder from the pages of state law reporters as interpreted by expensive legal advisers; they also know that liability, not aspirational norm, ultimately determines the legality of their decision. It is not clear why directors need a special legal framework, requiring expert reading of the tea leaves of Delaware jurisprudence, merely to inform them—in the most convoluted way that corporation law is expressed no less—that in essence they ought to act reasonably under the circumstances. I do not deny that a reminder of their duties in the boardroom may have tangible salutary value, but there is unquestionably a cost-benefit consideration attached to the provision of legal and financial opinions when the preaching of aspirational norms are made to be a necessary transaction cost.[83] If we are left only with an aspirational norm, the whole thing strikes of kabuki theater. This indulgence of judicial ceremony comes at the heavy cost of legal uncertainty and its progeny of derivative suits.[84] And, if the duty of care is simply an aspirational norm, one wonders whether the psychological effect of having a friendly reminder of the aspiration is really worth it, or whether the Sunday boardroom can do without the sermons.

The explanation of divergent standards is a strained and ultimately unconvincing justification for the narrow scope of the duty of care and the excision of courts from the substantive decisionmaking in corporate governance. These ends may well be justified as a matter of policy and theory, and in this respect the explanation of divergent standards serves the limited function of placing descriptive tags for the outcomes that the rules of law correctly achieve in most cases. However, the explanation raises the question without really answering it: Why does the duty of care beget an obligation while the business judgment rule seems to deny it? The answer—exceptionalism of corporate law—is not very satisfying or convincing. The divergence of the standards of conduct and review is not seen in most other areas such as torts, criminal law, environmental law, etc., all of which involve

83 *See generally* Steven J. Cleveland, *An Economic and Behavioral Analysis of Investment Bankers When Delivering Fairness Opinions*, 58 ALA. L. REV. 299 (2006) (providing a critique of the utility of fairness opinions); Steven M. Davidoff, *Fairness Opinions*, 55 AM. U. L. REV. 1557 (2006) (same).

84 *See* William J. Carney & George B. Shepherd, *The Mystery of Delaware Law's Continuing Success*, 2009 U. ILL. L. REV. 1 (2009) (arguing that Delaware law has become complex and uncertain resulting in increased litigation).

assessing individual decisions of great significance.[85] And, the core disjunction in the concept of board liability persists: the excusal of errors and bad judgments is something we do not see in other areas of law. As theory goes, the explanation creates a convenient illusion of plausibility supporting the consensus intuition that the systematic liability outcomes seen in corporation law are correct.

C. The Flawed Tort Analogy

The relationship between corporation law and tort law has been distant. Commentators have argued that tort law and corporation law are different because the goal of torts is loss spreading, whereas corporation law seeks to incentivize risk taking.[86] The tort system, it is argued, shifts loss from specific victims to a larger pool of risk-bearers through insurance and tort liability.[87] In the corporate setting, such robust liability scheme would concentrate risk by shifting loss from diversified shareholders to directors. These points are well taken, but they are incomplete. It is undercut by the existence of a substantial Directors & Officers insurance market. Furthermore, the argument is based on an incomplete conception of the tort system and it does not present a consensus view of the *raison d'être* of the tort system.[88]

Another important aspect of tort law is deterrence,[89] which is the prevailing law and economics perspective.[90] The most prominent example of this thought is the Hand Formula, which conceptualizes negligence as a cost-benefit analysis of accident and precautionary costs for the purpose of achieving optimal deterrence and social cost.[91] If corporation law imposes liability on directors to deter bad business decisions, the laws of torts and corporations should converge.

85 Eisenberg, *supra* note 4, at 437, 463.

86 BAINBRIDGE, *supra* note 1, at 262–63; Davis, *supra* note 3, at 575.

87 *See generally* Guido Calabresi, *Some Thoughts on Risk Distribution and the Law of Torts*, 70 YALE L.J. 499 (1961) (examining the theoretical justifications for tort law's aim of distributing losses).

88 There are many instances in tort law, especially mass torts and class actions, where diffuse losses are concentrated against a single defendant.

89 *See generally* WILLIAM M. LANDES & RICHARD A. POSNER, THE ECONOMIC STRUCTURE OF TORT LAW 4 & n.12 (1987) (explaining that an important element of tort law is to prevent like accidents from occurring in the future); Richard A. Posner, *A Theory of Negligence*, 1 J. LEGAL STUD. 29, 32–34 (1972) (considering what tort theory best affects human behavior to prevent accidents).

90 *See* A. Mitchell Polinsky & Steven Shavell, *Punitive Damages: An Economic Analysis*, 111 HARV. L. REV. 869, 877–904 (1998); Robert J. Rhee, *A Financial Economic Theory of Punitive Damages*, 111 MICH. L. REV. 33, 36, 52-53 (2012).

91 United States v. Carroll Towing Co., 159 F.2d 169, 173–74 (2d Cir. 1947); *see* LANDES & POSNER, *supra* note 89, at 104.

However, prominent corporate law jurists have referenced a director's care to that of a driver or doctor, and have rejected the analogy as "misleading"[92] and "not well-suited to judicial review."[93] The plainest statement of the underlying policy is found in *In re Caremark International Inc. Derivative Litigation*[94]: "It is doubtful that we want business men and women to be encouraged to make decisions as hypothetical persons of *ordinary* judgment and prudence might."[95] Scholars have also analogized a director's negligence to common torts, and have dismissed tort law as irrelevant.[96]

At first blush, this consensus view seems right. The duty of care is dressed in the language of torts,[97] and yet directors are not held to a negligence standard for business losses. Courts and scholars correctly argue that directors must not be held liable for negligent, stupid, careless, unlucky, or egregious decisions in spite of any visceral impulse to blame and levy liability for a bad outcome.[98] Of course, such a concept is antithetical to tort law. Since tort law finds liability for negligence and corporation law does not, inter-doctrinal divergence seems correct on the surface. But upon a deeper analysis this argument is flawed.

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92 Joy v. North, 692 F.2d 880, 885 (2d Cir. 1982).

93 *In re* Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 967 n.16 (Del. Ch. 1996).

94 *Id.*

95 *Id.* at 967–68 n.16.

96 *See, e.g.*, ALLEN ET AL., *supra* note 5, at 243; Allen et al., *Realigning*, *supra* note 4, at 454; Bainbridge, *supra* note 4, at 88; Davis, *supra* note 3, at 581–82; Hansen, *supra* note 4, at 1357–58; *see also* Charles Hansen, *The ALI Corporate Governance Project: Of the Duty of Due Care and the Business Judgment Rule, a Commentary*, 41 BUS. LAW. 1237, 1241 (1986) ("A careful reading of the cases illustrates the substantial difference between applying the due care test in tort law and the standard actually employed by the courts in reaching decisions under corporate law."); Rosenberg, *supra* note 64, at 310 (noting that most people would be "extremely reluctant to suggest that the concept of the reasonable person that pervades other areas of law (such as torts) should be applicable to corporate directors").

97 *See supra* notes 6 & 28 and accompanying text; *see also* EASTERBROOK & FISCHEL, *supra* note 1, at 93 (analogizing the fiduciary principle to tort law); Allen et al., *Function Over Form*, *supra* note 4, at 1301 ("Thus, claimed breaches of the duty of care were essentially subjected to traditional tort analysis, i.e., whether the duty was violated, and if so, whether the violation caused harm to the corporation or the shareholders, and the burden of proof fell upon the plaintiff."); Eisenberg, *supra* note 4, at 439 ("The duty of care of corporate directors and officers is a special case of the duty of care imposed throughout the law under the general heading of negligence."); Hansen, *supra* note 4, at 1355 ("The traditional formulation of a director's duty of care uses a 'reasonably prudent man' standard quite like that of tort law.").

98 *See supra* note 60.

The tort analogy fails because scholars and jurists have focused on the difference in judicial outcomes, and have wrongly assumed that the application of tort law would require a substantive review of business decisions under the negligence standard. However, the divergence of outcomes is not as meaningful, and the better inquiry focuses on the reasons why outcomes diverge, which is a search for a common analytical framework under which courts formulate duty and its limitation.

We start with the basic observation that the negligent doctor should be liable to his patient, or the negligent driver to the pedestrian, and so forth in the infinite ways negligence can result in liability. However, a cursory review of tort law also shows that liability can be cut off even when there has been a "wrong" or bad conduct in some ordinary, visceral sense. For example, when a railway employee negligently pushed a customer into a train thereby dislodging hidden explosives, he had no duty to a passenger standing in the distance who was injured in the subsequent explosion.[99] When a water company negligently failed to provide sufficient water to a city with which it had a contract to provide water, it had no duty to a city resident whose warehouse burned down due to inadequate water pressure.[100] When an accounting firm negligently certified the solvency of an insolvent client's balance sheet, it had no duty to a creditor who relied on the certification and made a bad loan to the client.[101] When a dry dock negligently damaged the propeller of a ship, thereby preventing the ship from carrying out its charter, it had no duty to the charterer of the ship for lost profit.[102] When a negligent driver caused a traffic delay in the Brooklyn Battery Tunnel, he had not committed a wrong to the investment banker who lost out on a million dollar deal resulting from the delay.[103] In each of these cases, the defendants could be said to have erred in conforming their behavior to some ideal standard, but in each case the court ruled that there was no legal wrong to the one who was injured. The analogy of a director's decision to a doctor's negligence, as frequently asserted in corporate law scholarship, misconceives the analysis.[104] A legal wrong is a flexible concept.

The duty of care in corporation law establishes the basic idea that a director owes a fiduciary duty to the corporation—a fairly uncon-

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99 Palsgraf v. Long Island R.R. Co., 162 N.E. 99 (N.Y. 1928) (Cardozo, C.J.).

100 H.R. Moch Co. v. Rensselaer Water Co., 159 N.E. 896 (N.Y. 1928).

101 Ultramares Corp. v. Touche, 174 N.E. 441 (N.Y. 1931).

102 Robins Dry Dock & Repair Co. v. Flint, 275 U.S. 303 (1927). .

103 *See In re* Kinsman Transit Co., 388 F.2d 821, 825 n.8 (2d Cir. 1968) (providing the hypothetical).

104 *See supra* note 96.

troversial point in the abstract. The controversy surrounds defining the scope of that duty and its theoretical justification. "Studies of corporate law have not inquired into the definition of a reasonable director because the prevailing wisdom has been that the law calls for no such inquiry."[105] Corporate law is exceptional, the argument goes, because if it is not, the scope of duty would encompass negligence for making substantive business decisions. This fear is misplaced.

II. Duty of Care and Affirmative Undertaking

What is the duty of care? What obligation does it impose? What are its limits? These questions can be answered in a theoretically coherent way, consistent with the policy prescriptions that accompany the business judgment rule, through the analytics of tort law.

In tort law, since one's actions can potentially harm many victims, it is said that a person owes a "duty to the world."[106] But strictly speaking, duty is not so expansive.[107] "Negligence, like risk, is thus a term of relation."[108] In most ordinary situations, the imposition of a foreseeable risk to a cognizable interest of another creates a sufficient relational nexus for duty to arise.[109] The requirement of a sufficient connection between actors independent of factual causation in a fortuitous event explains why there is no general duty to act affirmatively on behalf of someone's welfare absent some preexisting relationship or special circumstance.[110] When one undertakes such care[111] or

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105 Rosenberg, *supra* note 64, at 312.

106 *See* Palsgraf v. Long Island R.R. Co., 162 N.E. 99, 103 (N.Y. 1928) (Andrews, J., dissenting) ("The proposition is this: Every one owes to the world at large the duty of refraining from those acts that may unreasonably threaten the safety of others.").

107 *See generally* W. Jonathan Cardi & Michael D. Green, *Duty Wars*, 81 S. Cal. L. Rev. 671 (2008) (discussing the distinct treatment of the concept of duty in California courts and the Third Restatement); John C.P. Goldberg & Benjamin C. Zipursky, *Shielding Duty: How Attending to Assumption of Risk, Attractive Nuisance, and Other "Quaint" Doctrines Can Improve Decisionmaking in Negligence Cases*, 79 S. Cal. L. Rev. 329 (2006) (critiquing the diagnosis offered by Dilan Esper and Greg Keating concerning the California courts' abuse of the duty concept).

108 *Palsgraf*, 162 N.E. at 101.

109 "The risk reasonably to be perceived defines the duty to be obeyed, and risk imports relation; it is risk to another or to others within the range of apprehension." *Id.* at 100. *See* George P. Fletcher, *Fairness and Utility in Tort Theory*, 85 Harv. L. Rev. 537, 571 (1972).

110 *See, e.g.*, Hurley v. Eddingfield, 59 N.E. 1058 (Ind. 1901) (finding physician under no duty to render professional services to everyone who applied); Yania v. Bigan, 155 A.2d 343, 346 (Pa. 1959); Restatement (Second) of Torts § 314 (1965).

111 *See, e.g.*, United States v. Lawter, 219 F.2d 559, 562 (5th Cir. 1955); Restatement (Second) of Torts § 323 (1965); *see also* Charles O. Gregory, *Gratuitous Under-*

stands in a special relationship,[112] the law imposes a duty of care where there would otherwise have been none.

The modern public corporation is characterized by a separation of ownership and control in the corporation,[113] and this requires a board of directors to assume the mantle of managerial power on behalf of the corporation.[114] This affirmative undertaking and special relationship beget a director's duty of care. One need not belabor the point that directors owe a fiduciary duty of care to the corporation.[115] The primary instrumental function of the duty of care is to say that there *is* a legal duty as a matter of law, which seems readily apparent but is nevertheless a significant proposition requiring an affirmative statement of law.[116] However, the existence of a duty does not answer the more difficult question of the scope of that duty. Justice Frankfurter's famous statement on fiduciary duty is apropos:

> But to say that a man is a fiduciary only begins the analysis; it gives direction to further inquiry. To whom is he a fiduciary? What obligations does he owe as fiduciary? In what respect has he failed to discharge these obligations? And what are the consequences of his deviation from duty?[117]

The existence of a duty invokes the abstraction that a director must act reasonably, but it does not give substance to what "reasonable" means in the context of the voluntary association between the

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takings and the Duty of Care, 1 DePaul L. Rev. 30, 35 (1951); Warren A. Seavey, *Reliance upon Gratuitous Promises or Other Conduct*, 64 Harv. L. Rev. 913, 928 (1951).

112 *See, e.g.*, Brosnahan v. Western Air Lines, Inc., 892 F.2d 730, 733 (8th Cir. 1989) (discussing airline's duty to supervise boarding process for the safety of passengers); *In re* Trans-Pacific Fishing & Packing Co., 152 F. Supp. 44, 47 (W.D. Wash. 1957) (holding that a ship owners have a special obligation to the seamen employed on their ships to keep the ships seaworthy and in safe working condition); Tarasoff v. Regents of the Univ. of Cal., 551 P.2d 334, 340 (Cal. 1976) (discussing a therapist's duty to known potential victims of a violent patient; *see also* Restatement (Second) of Torts § 314A (1965).

113 Adolf A. Berle, Jr. & Gardiner C. Means, The Modern Corporation and Private Property (Macmillan Co. 1982) (1932).

114 *See* Del. Code Ann. tit. 8, § 141(a) (2010); Model Bus. Corp. Act § 8.01(b) (2011).

115 N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla, 930 A.2d 92, 101 (Del. 2007).

116 *Compare* Scott, *supra* note 4, at 937 (arguing that "very little of any value would be lost by outright abolition of the legal duty of care"), *with* Johnson, *Rethinking*, *supra* note 4, at 807 (arguing for "[r]estoring due care as a meaningful cornerstone of Delaware law"). *Cf.* Stephen J. Lubben & Alana J. Darnell, *Delaware's Duty of Care*, 31 Del. J. Corp. L. 589, 589 (2006) (observing that the duty of care no longer exists in Delaware).

117 Sec. & Exch. Comm'n v. Chenery Corp., 318 U.S. 80, 85–86 (1943).

director and the corporation. Tort law teaches us that "[p]roof of negligence in the air, so to speak, will not do,"[118] and likewise corporation law must give substance to the meaning of duty, negligence, and wrong.[119]

The nature of a director's undertaking of care invokes two principles of tort law that govern the scope of duty: (1) duty arising from affirmative undertaking; and (2) industry custom as to the standard of care.

A. *Duty from Undertaking*

Since the fiduciary duty of care arises out of a voluntary principal-agent relationship between the corporation and the director, [120] the scope of that duty is defined by the nature of affirmative undertaking. This view is consistent with the contractarian perspective that corporation law provides implied contractual terms of the relationship among factors of production.[121] Insofar as fiduciary duty is concerned, the contractarian analysis ultimately serves the tort function of defining the boundary of liability. The contract analogy is a convenient metaphor expressing the simple fact that, in an era in which involuntary servitude has long been eradicated, business enterprise is conducted through voluntary relationships among economic actors seeking gain. Moving forward from this obvious starting point, the tort analogy provides the legal framework defining the liability scheme. With that said, there is no clear analytic division between contract and tort anal-

118 Palsgraf v. Long Island R.R. Co., 162 N.E. 99, 102 (N.Y. 1928) (quoting FREDERICK POLLOCK, LAW OF TORTS 455 (11th ed. 1920)).

119 *See generally* John C.P. Goldberg & Benjamin C. Zipursky, *Torts as Wrongs,* 88 TEX. L. REV. 917 (2010) (discussing the nature of a civil wrong under tort law).

120 *See* RESTATEMENT (THIRD) OF AGENCY § 1.01 (2006).

121 *See* BAINBRIDGE, *supra* note 1, at 27–28 (describing the corporation as a "nexus of contracts"); EASTERBROOK & FISCHEL, *supra* note 1, at 12 ("So we often speak of the corporation as a 'nexus of contracts' or a set of implicit and explicit contracts."); *see also* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, 3 J. FIN. ECON. 305, 311 (1976) (describing a corporation as "simply one form of legal fiction which serves as a nexus for contracting relationships" (emphasis omitted)). This view of the corporation is not without criticism. *See* Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247 (1999) (looking to public corporation law as substitute for explicit contracts); *see also* William T. Allen, *Our Schizophrenic Conception of the Business Corporation*, 14 CARDOZO L. REV. 261 (1992) (describing competing theories of the corporation).

yses. Many tort problems of assigning liability can be analyzed through a contract prism.[122]

The principal term in the contract between the corporation and its directors is an undertaking of care. The duty to care is not met merely by a demonstration of scienter alone. A good-hearted director of empty deeds is not privileged in the eyes of the law. The duty to care requires affirmative acts of care. In concrete terms, this means that directors must act in good faith toward exercising corporate powers in furtherance of the corporate interest. If so, we expect to see judicial rulings that, notwithstanding the business judgment rule, a breach of the duty of care may result from dereliction of duty, failure to exercise responsibility, and lack of good faith effort toward the care of the corporation.[123] Such a line of cases has long existed.

In *Briggs v. Spaulding*,[124] a bank went insolvent as a result of misconduct of its officers and employees, and the plaintiffs sued the directors on the theory that they failed to adequately supervise and monitor the bank.[125] The court held:

> They are entitled under the law to commit the banking business, as defined, to their duly-authorized officers, but this does not absolve them from the duty of reasonable supervision, nor ought they to be permitted to be shielded from liability because of want of knowledge of wrong-doing, if that ignorance is the result of gross inattention . . . .[126]

Thus the duty "includes something more than officiating as figureheads."[127]

In *Barnes v. Andrews*,[128] a bankruptcy receiver sued a director for the failure of a corporation, arguing on the theory that the director was guilty of neglect, omission, and inadequate oversight.[129] Interestingly, the cause of action was brought under tort law on the theory of omission when there is a duty to act.[130] The trial judge, Learned

122 "Hypothetical-contract analysis is a powerful tool for understanding tort law and determining its scope." Stockberger v. United States, 332 F.3d 479, 483 (7th Cir. 2003).

123 *See* Eisenberg, *supra* note 4, at 448 ("Accordingly, the duty to monitor, the duty of inquiry, and the duty to employ a reasonable decision-making process are normally not protected by the business-judgment rule.").

124 Briggs v. Spaulding, 141 U.S. 132 (1891).

125 *Id.* at 134–38. The case was subsequently overruled on the ground that it violated the *Erie* doctrine. Atherton v. FDIC, 519 U.S. 213, 226 (1997).

126 *Briggs*, 141 U.S. at 165–66.

127 *Id.* at 165.

128 Barnes v. Andrews, 298 F. 614 (S.D.N.Y. 1924)

129 *Id.* at 615–16.

130 *Id.* at 616.

Hand, found that the defendant failed to keep informed and was a "figurehead," and liability could be imposed for a failure of duty.[131] However, the court ruled that the receiver failed to show causation between the director's negligence and the corporation's financial injury.[132]

In *Francis v. United Jersey Bank*, [133] a director failed to monitor the company, abdicated all responsibility for oversight, including a failure to attend board meetings, and was unqualified to perform the tasks of a director because she did not understand the business at a basic level. Reasoning that "all directors are responsible for managing the business and affairs of the corporation," the court imposed liability against the neglectful director, and made clear that the key sin was her failure to undertake affirmative care of the corporation.[134]

In *Graham v. Allis-Chalmers Manufacturing Co.*, the plaintiff argued that the directors failed to take action designed to uncover and prevent violations of federal antitrust laws.[135] The Delaware Supreme Court stated that "absent cause for suspicion there is no duty upon the directors to install and operate a corporate system of espionage to ferret out wrongdoing which they have no reason to suspect exists."[136] However, the court made clear that if a director "has refused or neglected cavalierly to perform his duty as a director, or has ignored either willfully or through inattention obvious danger signs of employee wrongdoing, the law will cast the burden of liability upon him."[137]

In *In re Caremark International Inc. Derivative Litigation*, Chancellor William Allen ruled that liability for failure to monitor occurs only upon "a sustained or systematic failure of the board to exercise oversight—such as an utter failure to attempt to assure a reasonable information and reporting system [exists] . . . ."[138] This standard is consistent with the idea that a director must affirmatively care for the corporation, but there is no obligation to provide some objective, negligence-based level of care. Findings of liability are rare because an

131 *Id.* at 615–16.

132 *Id.* at 617. *Barnes* stands for the proposition that negligence must cause an injury for liability to attach. BAINBRIDGE, *supra* note 1, at 288–89; CLARK, *supra* note 1, at 126. This is perfectly consistent with tort law as the inquiry of the breach of duty is separate from causation. Martin v. Herzog, 126 N.E. 814, 816 (N.Y. 1920).

133 Francis v. United Jersey Bank, 432 A.2d 814 (N.J. 1981).

134 *Id.* at 823–24. "The sentinel asleep at his post contributes nothing to the enterprise he is charged to protect." *Id.* at 822.

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

136 *Id.* at 130.

137 *Id.*

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

uncaring director is functionally the equivalent of a director who has abdicated her duty to undertake care within the social and institutional setting of a bard and fellow peers. This explains why a failure of the duty to monitor is "possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment."[139]

In the *Disney* litigation, the Delaware Chancery Court defined bad faith as the intentional dereliction of duty: "Deliberate indifference and inaction *in the face of a duty to act* is, in my mind, conduct that is clearly disloyal to the corporation. It is the epitome of faithless conduct."[140] A failure of good faith may be shown "where the fiduciary intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties."[141] On appeal, the Delaware Supreme Court endorsed these standards.[142]

In *Stone v. Ritter*, the Delaware Supreme Court endorsed the *Caremark* standard of "sustained or systematic failure" of oversight, but categorized this type of failure as a duty of loyalty violation.[143] Echoing the language in its *Disney* opinion, the court reiterated: "Where directors *fail to act in the face of a known duty to act*, thereby demonstrating a conscious disregard for their responsibilities, they breach their duty of loyalty by failing to discharge that fiduciary obligation in good faith."[144] Thus, duty is framed as a conscious disregard of one's affirmative responsibilities.[145]

This line of cases shows that the duty of care is not meaningless verbiage, which is not to say that liability is or should be commonplace. When the scope of duty is viewed as a duty of affirmative undertaking, there is the real possibility of liability.[146] Liability is predicated

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139 *Id.* at 967.

140 *In re* Walt Disney Co. Derivative Litig., 907 A.2d 693, 755 (Del. Ch. 2005) (footnote omitted).

141 *Id.*

142 *In re* Walt Disney Co. Derivative Litig., 906 A.2d 27, 62–67 (Del. 2006).

143 Stone v. Ritter, 911 A.2d 362, 369–70 (Del. 2006).

144 *Id.* at 370 (emphasis added) (footnote omitted). This conscious disregard standard is similar to the tort definition of intent. *See* RESTATEMENT (SECOND) OF TORTS § 8A (1965) ("The word 'intent' . . . denote[s] that the actor . . . believes that the consequences are substantially certain to result from it.").

145 The Delaware Supreme Court characterized a *Caremark* violation as a violation of the duty of loyalty. *Stone*, 911 A.2d at 370.

146 As one commentator has noted, "similar patterns of exacerbated neglect constitute the only circumstances in which directors have been found liable in the non-decision-making context in spite of the use of the tort-derived formulation of the duty of care." Hansen, *supra* note, 96 at 1248 & n.45 (listing cases exemplifying this pattern). "Accordingly, the duty to monitor, the duty of inquiry, and the duty to employ a reasonable decision-making process are normally not protected by the business-judgment rule." Eisenberg, *supra* note 4, at 448.

on a failure to undertake the care of the corporation, and this is consistent with the rule that the business judgment rule protects directors only when they have taken action by exercising judgment.[147] Liability is few and infrequent not because most boards always make correct substantive decisions, but because we do not expect to see a breach of the fundamental obligation agreed upon between a corporation and a board through systematic failure of the cohort of directors forming an institution that is legally obligated to care for the corporation, though sometimes this happens or is adjudged to have occurred.[148]

B. Custom as the Scope of Duty

In defining the scope of duty, courts have distinguished between a failure to undertake affirmative care and a failure to undertake *sufficient* care. The question is: Why isn't sufficient care a fundamental obligation of the duty of care between the corporation and the board? The tort principle of customs in establishing the standard of care informs the answer.

The tort doctrine of customs provides the concrete analytical framework of the rules of law governing duty and liability. When parties are constituents of a market, many tort problems of allocating losses can be analyzed as a contract problem concerning industry customs and standards. Samuel Arsht has hinted a connection between industry customs under tort law and a director's scope of duty under corporate law: "[T]he primary function of the business judgment rule may be simply to accord to directors the same necessary protection that professionals enjoy under Anglo-American tort law if sued for malpractice."[149] This insight requires further development.

With respect to customs of an industry or profession, courts determine the scope of one's duty under the principle set forth in Learned Hand's opinion in *The T.J. Hooper*.[150] There, Hand famously

147 *See* Aronson v. Lewis, 473 A.2d 805, 813 (Del. 1984) ("[The business judgment rule] has no role where directors have either abdicated their functions, or absent a conscious decision, failed to act."); Johnson, *Rethinking, supra* note 4, at 808 ("Director neglect of corporate affairs, or a director's abdication of his or her duties, is a violation of care in this most fundamental, statutory sense."); *supra* note 51.

148 *See* Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 361 (Del. 1993); Smith v. Van Gorkom, 488 A.2d 858, 864 (Del. 1985); *September 21, 2005: Court Grants Final Approval of all Settlements*, WORLDCOM SEC. LITIG., http://www.worldcomlitigation.com/ (last updated Oct. 2, 2012) (indicating that the directors of WorldCom personally paid $24,750,000 in liability as a part of a settlement for the collapse of the company during their tenure).

149 Arsht, *supra* note 4, at 97.

150 The T.J. Hooper, 60 F.2d 737 (2d Cir. 1932).

advanced this proposition: "Courts must in the end say what is required; there are precautions so imperative that even their universal disregard will not excuse their omission."[151] However, the principle in *T.J. Hooper* is modified somewhat when contractual constituents are seen as fixing the standard of care with respect to market transactions amongst themselves. For example, in the realm of professional malpractice the implied and express terms of the industry standard of care is often dispositive.[152]

Judge Richard Posner's opinion in *Rodi Yachts, Inc. v. National Marine, Inc.*[153] illustrates a contractarian analysis of customary industry standards in accident law. There, a barge owned by *A* cast adrift when it slipped its moorings at a dock operated by *B*, and collided with another dock and two boats, causing damages to *P*.[154] The defendants *A* and *B* conceded that at least one of them was liable to *P*.[155] The issue concerned the allocation of liability between *A* and *B*. Posner begins the analysis with this emphasis: "Although in form a tort case, in economic reality this is a contract case."[156] The principle set forth in *The T.J. Hooper* "is obviously sound when one is speaking of the duty of care to persons with whom the industry whose customary standard of care is at issue has no actual or potential contractual relation."[157] Only through tort liability can the costs of injury be made a cost to industry, thus deterring socially undesirable activities.[158] But when the parties are bound together in a market relationship, "the market itself fixes a standard of care that reflects the preferences of potential victims as well as of potential injurers and then the principal function of tort law, it could be argued, is to protect customers' reasonable expectations that the firms with which they deal are complying with the standard of care customary in the industry, that is, the standard fixed by the market."[159] While courts ultimately set the standard of care, they should defer to the implied expectations of market

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151 *Id.* at 740 (citations omitted).

152 *See* WARD FARNSWORTH & MARK F. GRADY, TORTS: CASES AND QUESTIONS 166 (2d ed. 2009) ("[M]edical malpractice is an unusual area of tort law where compliance with custom is decisive rather than just evidentiary.").

153 Rodi Yachts, Inc. v. Nat'l Marine, Inc., 984 F.2d 880 (7th Cir. 1993).

154 *Id.* at 881.

155 *Id.* at 882.

156 *Id.*

157 *Id.* at 888.

158 *Id.* (citing R.H. Coase, *The Problem of Social Cost,* 3 J.L. & ECON. 1 (1960)).

159 *Id.* at 888–89.

participants in determining the loss allocation amongst them, *i.e.*, the scope of liability.[160]

The doctrine and principle of industry customs provide essential insights into corporation law's liability scheme. Since the basis of a director's duty of care is the assent of the agent to serve, the scope of a director's duty of care should be based on an implied contract analysis.[161] The implied contractual terms on the scope of duty are fairly clear, and are seen in the many policy justifications for the business judgment rule. One such policy reason is that rational directors would surely not assume the risk of liability for mistakes, whether determined to be negligent or not.[162] Directors are not compensated to assume enormous risk; they are not an insurer of the corporation's economic value. They would be poor substitutes for more efficient means to insure against the exposure to any given stock. Shareholders can mitigate exposure to the risk of any given stock through hedging or diversification. Since an investment in the market cannot be guaranteed, which is to say that equity investments are never risk-free, directors would not agree to provide downside protection to the corporation or shareholders. Any attempt to impose that term of agency would result in no undertaking at all. As Judge Ralph Winter has explained, "the business judgment rule merely recognizes a certain voluntariness in undertaking the risk of bad business decisions."[163] This understanding is a basic condition of a director's service.[164] The corporation and shareholders must assume the risk of economic loss, lest directors will not assume the obligation of care.

The implied understanding does not go so far as producing a liability-free scope of duty because the bargaining for terms is not one-sided. Aside from the irrationality of the oxymoron, any attempt by

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160 *See* RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW §6.3 (8th ed. 2011) (criticizing Hand's approach in *The T.J. Hooper*).

161 *See* EASTERBROOK & FISCHEL, *supra* note 1, at 12 ("[T]he corporation is a voluntary adventure, and that we must always examine the terms on which real people have agreed to participate.").

162 "The reason, bluntly stated, is that corporate directors and officers invest other people's money. They bear the full costs of any personal liability, but they receive only a small fraction of the gains from a risky decision." ALLEN ET AL., *supra* note 5, at 243.

163 Joy v. North, 692 F.2d 880, 885 (2d Cir. 1982).

164 *See* Arsht, *supra* note 4, at 97; Balotti & Hanks, *supra* note 66, at 1342; Block et al., *supra* note 4, at 490; McMurray, *supra* note 27, at 616; *see also* Smith v. Brown-Borhek Co., 200 A.2d 398, 401 (Pa. 1964) ("Such persons would rarely ever accept a directorship if they could be held liable for every 'bad' account or every mistake of judgment."); Percy v. Millaudon, 8 Mart. (n.s.) 68, 78 (La. 1829) ("No man would undertake to render a service to another on such severe conditions.").

directors to seek a "no liability" term in hypothetical bargaining would result in a rejection of the undertaking by the corporation.[165] Directors must bond their agreement to serve with some enforceable obligation.

The nature of a director's obligation is obfuscated by a mischievous misnomer of preposition. The duty *of* care is descriptively better stated as a duty *to* care.[166] The ordinary use of "duty of care" as a term of legal art is shorthand for the duty to comply with some substantive level of prescriptive care, independent of good faith scienter, and attempt to comply with the prescription. This concept is seen in tort law's rejection of the stupid person defense.[167] The term is routinely used without much thought to its semantic construction because in most tort cases it conveys the right idea of focusing on the quality of care. But it does mischief when its shorthand definition clouds the nature of the obligation. The prepositional correction "duty *to* care" is more than a superficial semantic change. It emphasizes intent invoking a quality of good faith undertaking. This distinction goes to the heart of Delaware's substantive-procedural dichotomy. In an arms-length bargaining with the corporation for the terms of service, rational directors would agree that their obligation is fundamentally custodial in nature. The directors have taken an affirmative obligation to take custody of the corporation, which is the core of the separation of ownership and control, and consistent with this obligation they have undertaken the duty to care for the corporation.

At the core of this duty is a director's good faith and honest intention as evinced by affirmative deeds consistent with their heart. In short, directors have a duty to care for the corporation, which manifests in the affirmative engagement of activities consistent with good faith intention to care—a duty to exercise business judgment, to monitor, and generally to assume the mantle of authority and responsibility.[168]

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165 *See* Larry E. Ribstein, The Rise of the Uncorporation 37 (2010) ("When filling gaps in the corporate contracts, courts cannot look to the actual intent of thousands of parties so they make up a hypothetical 'intent' based on what the courts view as reasonable.").

166 Indeed, Lyman Johnson has previously focused on the custodial nature of a director's duty, and as a result he formulated a similar construction of the term: "The board therefore is to 'take care of' the corporation's business and affairs . . . . [A violation of care] is a failure to direct, or 'take care of,' the corporation." Johnson, *supra* note 4, at 808.

167 *See supra* note 61.

168 *See* Johnson, *supra* note 4, at 807–08.

This understanding is consistent with the business judgment rule. This passage nicely summarizes the concept:

> [H]ow does the operation of the . . . "business judgment rule" tie in with the concept of negligence? There is no conflict between the two. When courts say that they will not interfere in matters of business judgment, it is presupposed that judgment—*reasonable diligence*—has in fact been exercised. A durector [sic] cannot close his eyes to what is going on about him in the conduct of the business of the corporation and have it said that he is exercising business judgment. Courts have properly decided to give directors a wide latitude in the management of the affairs of a corporation provided always that judgment, and that means an honest, unbiased judgment, is reasonably exercised by them.[169]

In other words, the failure to undertake affirmative, good faith care of the corporation *defines* the meaning of "negligence" in the context of corporation law. The modern formulation of the business judgment rule incorporates the definition of negligence when it presumes that in making a business decision a director "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."[170] A shareholder must overturn this presumption, which is to say that he must prove a breach of duty, by presenting particular evidence to the contrary on these matters: a business action was taken; the decision was not informed; or it was not in good faith. Thus, the business judgment rule gives substance to the question: What does it mean when we say that a director has been negligent and failed to meet the standard of care?

The critical misunderstanding has been a conflation of an "error" with a "wrong," and the resulting strained efforts to rationalize two conflicting visceral senses: on the one hand the correctness of the case outcomes, and on the other hand the felt need for accountability for mistakes. This tension is also seen in tort law. In torts, negligence is always an error, but an error is not always a civil wrong. The applicable principle was famously set forth by Cardozo in *Palsgraf*: The scope of duty cannot be discerned by reference to an isolated examination of the quality of the conduct for it "is built upon the shifting meanings of such words as 'wrong' and 'wrongful,' and shares their instability."[171] While a director could be said to have committed a "mistake"

169 Casey v. Woodruff, 49 N.Y.S.2d 625, 643 (Sup. Ct. 1944) (emphasis added).

170 Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984).

171 Palsgraf v. Long Island R.R. Co., 162 N.E. 99, 100 (N.Y. 1928).

or an "error" upon a demonstrably poor decision,[172] the legal concept of duty does not support such a definition. "Negligence in the abstract, apart from things related, is surely not a tort, if indeed it is understandable at all."[173] One of the earliest applications of the business judgment rule, seen in *Percy v. Millaudon*, recognized this tort-based principle of duty:

> The only correct mode of ascertaining whether there was fault in an agent, is by enquiring whether he neglected the exercise of that diligence and care, which was necessary to a successful discharge of the duty imposed on him. That diligence and care must again *depend on the nature of the undertaking*. There are many things which, in their management, require the utmost diligence, and most scrupulous attention, and where the agent who undertakes their direction, renders himself responsible for the slightest neglect. There are others, where the duties imposed are presumed to call for nothing more than ordinary care and attention, and where the exercise of that degree of care suffices.
>
> The directors of banks from *the nature of their undertaking*, fall within the class last mentioned, while in the discharge of their ordinary duties. . . . In relation to these officers, the duties of directors are those of controul, and *the neglect which would render them responsible for not exercising that controul properly, must depend on circumstances*, and in a great measure be tested by the facts of the case. If nothing has come to their knowledge, to awaken suspicion of the fidelity of the president and cashier, ordinary attention to the affairs of the institution is sufficient. If they become acquainted with any fact calculated to put prudent men on their guard, a degree of care commensurate with the evil to be avoided is required, and a want of that care certainly makes them responsible.[174]

The point in *Percy* illustrates Cardozo's concept that wrongs cannot be discerned in the abstract, but that the determination depends on "the nature of the undertaking."[175] Tort law readily provides the core principle that certain conduct, like firing a gun randomly, is wrong in some circumstances (*e.g.*, in a crowded city) and not wrong in other circumstances (*e.g.*, on a deserted island).

In the corporation law context, market participants set the implied terms of care. The failure to conform one's action to a reasonable person has shifting meanings. The inquiry in tort cases

172 *See, e.g.*, Kamin v. American Express Co., 383 N.Y.S.2d 807, 812 (Sup. Ct. 1976), *aff'd*, 387 N.Y.S.2d 993 (App. Div. 1976).

173 *Palsgraf*, 162 N.E. at 101 (citations omitted).

174 Percy v. Millaudon, 8 Mart. (n.s.) 68, 74–75 (La. 1829) (emphasis added).

175 *Id.* at 74.

focuses on the quality of the particular decision and the outcome as the measure of reasonableness, and thus an error in judgment results in a legal wrong. The inquiry in corporation law focuses on the demonstrable effort and the quality of decisionmaking as the measure of reasonableness, and thus an error in judgment is not a wrong. The answer to the question—what would a reasonable director do?—does not lie in a review of the substance of the business decisions,[176] but instead on the substance of good faith and effort made by the custodians toward the care of the corporation.

III. Business Judgment and Economic Loss

The conventional account of the failed tort analogy is also flawed because commentators have analogized the rules in corporate law to rules in tort law applicable to physical loss. The assumption is wrong, leading to a wrong analysis. Tort law distinguishes the interests at stake and the types of harms suffered, leading to different doctrinal frameworks for assessing liability.[177] For example, emotional harms and pure economic losses are treated differently than injuries to person or property.[178] Melvin Eisenberg has noted this distinction.[179] Robert Thompson has gone so far as to suggest a possible link between the doctrine of pure economic loss and the corporate liability scheme:

> Tort law provides a structure to understand the separate "wrongfulness" of fraud, but in a way that also could suggest limits on recovery. By recognizing lying as a wrong, law recognizes this conduct as an inappropriate way of treating people that gives rise to an individual right of redress, separate from the substantive decision. But as a dignitary tort different from traditional physical torts, there might be additional limits in the same way that common law courts have

176 Other commentators have suggested the same: "[I]f a director has no conflicting interest, is reasonably informed, and makes a good-faith judgment . . . , what possible basis for liability exists? The answer, we think, is that there is none—not because the business judgment rule exists but because there is no breach of directorial duty." Allen et al., *supra* note 5, at 256.

177 *See* Cardi & Green, *supra* note 107, at 673–82.

178 *See generally* Robert J. Rhee, *A Principled Solution for Negligent Infliction of Emotional Distress Claims*, 36 Ariz. St. L.J. 805, 806 (2004) (analyzing emotional distress claims); Rhee, *supra* note 22, at 50 (providing a theory of the doctrine of pure economic loss).

179 *See* Eisenberg, *supra* note 4, at 444 ("[U]nlike most types of negligence cases, negligent decisions by directors or officers characteristically involve neither personal injury nor economic damages that are catastrophic to an individual.").

continued to put limits on pure economic loss cases different from physical torts.[180]

Eisenberg and Thompson make an important point about the nature of the corporation's injury. They have pointed us in the right direction. The next step in constructing a corrected tort analogy is an interdoctrinal analysis of principles and theories governing pure economic loss.

The rule of pure economic loss is simply stated: While there is a general duty of care to avoid foreseeable physical harm,[181] there is no duty to take precaution against negligently inflicted pure economic loss.[182] This rule is seen in Holmes' opinion in *Robins Dry Dock & Repair Co. v. Flint*.[183] The plaintiff charterer suffered lost profits when the defendant dry dock negligently damaged the propeller of the owner's boat.[184] The Court held that the dry dock had no duty to the charterer and set forth the general rule that "a tort to the person or property of one man does not make the tortfeasor liable to another merely because the injured person was under a contract with that other, unknown to the doer of the wrong."[185] The pure economic loss rule and the business judgment rule share a number of commonalities. Both are nearly universal.[186] Both have been traditionally explained in instrumental, pragmatic terms, focusing on the problem created by broad exposure to liability for defendants.[187] Both invoke the principle that the law abhors disproportionate liability or penalty.[188]

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180 Thompson, *supra* note 19, at 889.

181 *See* RESTATEMENT (THIRD) OF TORTS: LIABILITY FOR PHYSICAL AND EMOTIONAL HARM §7(a) & cmt. a reporters' note (Proposed Final Draft No. 1 2005).

182 *See* Rhee, *supra* note 22, at 56; *see, e.g.*, *In re* Kinsman Transit Co., 388 F.2d 821, 824 (2d Cir. 1968); Rickards v. Sun Oil Co., 41 A.2d 267, 269–70 (N.J. 1945). The pure economic loss rule dates back to the birth of negligence. *See* Conn. Mut. Life Ins. Co. v. N.Y. & N.H. R.R., 25 Conn. 265, 270 (1856); Cattle v. Stockton Waterworks Co. [1875] 10 Q.B. 453 at 457.

183 Robins Dry Dock & Repair Co. v. Flint, 275 U.S. 303 (1927).

184 *Id.* at 307.

185 *Id.* at 309

186 The rule of pure economic loss is virtually universal. *See* Robert L. Rabin, *Respecting Boundaries and the Economic Loss Rule in Tort*, 48 ARIZ. L. REV. 857, 858 (2006); Rhee, *supra* note 22, at 56.

187 *See* Louisiana *ex rel.* Guste v. M/V Testbank, 752 F.2d 1019, 1028–29 (5th Cir. 1985) (en banc); Barber Lines A/S v. M/V Donau Maru, 764 F.2d 50, 54 (1st Cir. 1985); Fleming James, Jr., *Limitations on Liability for Economic Loss Caused by Negligence: A Pragmatic Appraisal*, 25 VAND. L. REV. 43, 48 (1972); Stephen R. Perry, *Protected Interests and Undertakings in the Law of Negligence*, 42 U. TORONTO L.J. 247, 262 (1992).

188 *See* Robert L. Rabin, *Tort Recovery for Negligently Inflicted Economic Loss: A Reassessment*, 37 STAN. L. REV. 1513, 1526, 1534 (1985); *see also* Gagliardi v. Trifoods Int'l, Inc.,

These commonalities merit an analysis of the link between the pure economic loss rule and the business judgment rule. At the outset, I note that doctrinal analysis and comparison have one distinction. Typically, in torts cases the ex ante relation between the defendant and the plaintiff are remote, and they are connected only by the accident resulting in economic loss; in corporate cases, there is already a fiduciary relationship between a director and the corporation.[189] While this distinction limits the doctrinal utility of the comparison, the theory of pure economic loss is relevant to the question in corporate law: What is the theoretical justification for not imposing a legal duty on a director to avoid negligently inflicting economic loss on the corporation?

Two economic analyses explain the theoretical underpinning of pure economic loss. One focuses on a microeconomic analysis of social cost. The other focuses on a political economic analysis of uncertainty and profit.

A. Social Cost of Economic Loss

William Bishop argued that the rule denies liability for pure economic loss because in many cases there is not a social cost.[190] In the case of a physical loss such as lost lives or damaged property, the social cost is apparent, but in economic loss cases there is often a transfer payment—that is, a private cost to one is an equal private benefit to another.[191] By imposing liability, the law may over-deter an activity that is otherwise efficiently deterred for the purpose of mitigating social cost. This theory is important and has an appealing elegance.

A typical fact-pattern illustrating the concept is seen in *532 Madison Avenue Gourmet Foods, Inc. v. Finlandia Center, Inc.*[192] A building collapse closed a Manhattan street.[193] The plaintiff delicatessen did not incur a physical loss but did suffer lost profit.[194] It sued the negligent parties who caused the building collapse, but the court held

683 A.2d 1049, 1052 (Del. Ch. 1996) ("Given the scale of operation of modern public corporations, this stupefying disjunction between risk and reward for corporate directors threatens undesirable effects.").

189 However, the existence of the fiduciary relationship relates back to an analysis of implied customary terms between the principal and the agent, and the implied professional standard provides the standard of liability.

190 Bishop, *supra* note 21, at 4.

191 *Id.*

192 *532 Madison Ave. Gourmet Foods, Inc. v. Finlandia Ctr., Inc.*, 750 N.E.2d 1097, 1100 (N.Y. 2001).

193 *Id.* at 1099.

194 *Id.* at 1100.

that they did not owe a duty to the plaintiff under the doctrine of pure economic loss.[195] The economic harm was not a social cost. Since there is a deli in virtually every city block in Manhattan, the plaintiff's lost profit was offset by gains of other stores. Bishop's theory works well to explain the denial of recovery.

Bishop concedes that his theory is too simple.[196] The assessment of social cost often "depends upon innumerable particular facts of interacting markets."[197] The theory depends on empirically unverified assumptions: for example, sufficient excess capacity to meet demand overflow by competitors; no marginal cost increases associated with capacity increase; elasticity of supply and demand as to substitute inputs, goods, and services; investor risk neutrality towards variability of returns under different liability rules, and so forth.[198] If we relax these assumptions, the hypothesis of no social cost is far more complicated.[199] But in most cases the administrative costs of a detailed economic inquiry would exceed whatever social cost was lost in most cases.[200] Ultimately, Bishop's theory depends on the hypothesis that "financial losses are only poorly correlated with social cost,"[201] thus justifying a blanket rule of no duty.

Despite the limitation of Bishop's theory, the core idea—that pure economic loss from negligence is frequently not a social cost—is important in thinking about liability for economic loss from poor board decisions. In many situations involving business decisions, the private loss of the corporation and shareholders is apparent, but the social cost is not. The distributional aspect of value and wealth in many market transactions results in transfer payments for which the social cost is less apparent. More broadly, the Schumpeterian process of "creative destruction"[202] assumes that private loss of firms leads not to social cost, but in fact social gain in the form of innovation and value creation built on the ruins of lesser firms and business models. To be sure, there are cases where the social cost is readily apparent. The clearest example is Enron where the board's sustained failure over a period of time resulted in the collapse of a corporation that

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195 *Id.* at 1099.

196 Bishop, *supra* note 21, at 11.

197 *Id.* at 13.

198 *Id.* at 11.

199 *Id.* at 13.

200 *Id.* at 17.

201 W. Bishop, *Economic Loss: A Reply to Professor Rizzo*, 2 OXFORD J. LEGAL STUD. 207, 207 (1982). The assumption is "an empirical question" whose validity is unknown and most probably unverifiable. *Id.* at 208.

202 JOSEPH A. SCHUMPETER, CAPITALISM, SOCIALISM AND DEMOCRACY 83 (1950).

previously was a legitimate business.[203] Even in such cases, however, the complex interactions with other market participants make the accounting of gains and losses inordinately difficult even when the magnitude of the loss suggests that there has been a net social loss. In most cases of ordinary business loss, the intuition is that economic loss resulting from poor business decisions are loosely, if not poorly, correlated with social cost in a competitive market.

Bishop's idea explains, in part at least, the judicial reluctance to assess liability after a poor decision resulting in economic loss. In many cases of bad business outcomes there is simply a transfer payment. Corporate law scholars and courts assume that shareholders of public companies hold a diversified portfolio.[204] A shareholder diversifies away firm-specific risk and is exposed only to market risk. In the case of a transfer payment, the individual gains and losses net out in a portfolio, suggesting that the diversified shareholder is not economically harmed from a board's "negligent" decision.

Even if there is some social cost, as a more detailed economic analysis may show, in many instances of business loss, the administrative cost of ascertaining it would be high. Judicial review is imperfect to the task even as courts are competent to conduct such analysis. Commentators have argued that liability rules as a corrective for director error are inferior to market monitoring of agent performance. Many disputes in torts or contracts are one-shot deals that require judicial resolution to correct fault or breach.[205] On the other hand, corporations have long-term relations that create repeated opportunities for directors to internalize the cost they impose without judicial intervention.[206] Market forces can monitor director error and competence. The capital market assesses the quality of the management when it assigns the firm's cost of capital.[207] The labor market monitors executives and directors by assigning differential values to their labor.[208] The capital markets *qua* information markets are efficient on some level.[209] Capital markets serving as monitors are said to

203 *See generally* MALCOLM S. SALTER, INNOVATION CORRUPTED (2008) (identifying and analyzing the business, ethical, and legal causes of the Enron collapse).

204 Joy v. North, 692 F.2d 880, 886 (2d Cir. 1982); *In re* Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 967–68 n.16 (Del. Ch. 1996); Gagliardi v. Trifoods Int'l, Inc., 683 A.2d 1049, 1052 (Del. Ch. 1996); EASTERBROOK & FISCHEL, *supra* note 1, at 29. *See generally* Harry Markowitz, *Portfolio Selection*, 7 J. FIN. 77, 79 (1952) (providing the intellectual foundation of modern portfolio theory).

205 EASTERBROOK & FISCHEL, *supra* note 1, at 94.

206 *Id.* at 94–95.

207 *Id.* at 95–97; BAINBRIDGE, *supra* note 1, at 257.

208 EASTERBROOK & FISCHEL, *supra* note 1, at 95–97.

209 *Id.* at 96.

be superior to courts because the judicial process is costly, and because courts may have difficulties reconstructing the ex ante risks.[210]

The argument of an imperfect judicial process is more plausible than one based on judicial incompetence, but it does not wholly explain the business judgment rule. It presents a simplistic binary choice between judicial review and market monitoring. Markets are not perfect in assessing corporate decisions and quality of management. For instance, the labor market should create proper incentives through "*ex post* settling up,"[211] but the current problem of excessive executive compensation calls into question whether this "settling up" process is efficient, or even works when the amount of compensation diminishes an executive's long-term incentives.[212] Nor are the capital markets perfect in assessing the quality of corporate decisions. Companies like Enron, Worldcom, Lehman Brothers, Bear Stearns, Merrill Lynch, Citigroup, and AIG were once market darlings. Collectively these very large, important companies, among many other inglorious peers, failed within a decade of each other, and this fact alone speaks to the imperfection of the markets. The process of credit ratings has exhibited systematic flaws for many years.[213] More fundamentally, uncertainty in the intrinsic value of an asset is the paradox upon which markets exist.[214] The value of an asset cannot be perfect and must fluctuate around the intrinsic value within a broad band constituting the margin of market error.[215] If so, it follows that markets can and sometimes do err badly.[216] Even if the market is better at monitoring than judicial review as a general proposition, the next step—that the two constitute a binary choice—does not necessarily follow.

Much like the limitations of Bishop's hypothesis, the argument that the market should (almost) exclusively determine error rests on a proposition incapable of empirical confirmation: Whether the market or the judiciary is better suited to determine the good and bad of board decisions. Courts are uniquely competent to assess past events,

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210 *Id.* at 98–99.

211 *Id.* at 95 (citing Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288, 295–306 (1980)).

212 *See generally* LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE (2006) (arguing that executive compensation is not correlated to performance).

213 *See* Frank Partnoy, *The Siskel and Ebert of Financial Markets?: Two Thumbs Down for the Credit Rating Agencies*, 77 WASH. U. L.Q. 619, 654–55 (1999).

214 Fischer Black, *Noise*, 41 J. FIN. 529, 530–34 (1986).

215 This band may be characterized as a factor of two, meaning that at any given time the stock can be undervalued by as much as 100 percent or overvalued by as much as fifty percent. *Id.* at 533.

216 *See* ROBERT J. SHILLER, IRRATIONAL EXUBERANCE 2 (2d ed. 2005).

actions, and wrongs given a legal standard. Egregious decisions and other howlers can be called for what they are without calling into question all bad outcomes. Despite the imperfection of judicial review, courts routinely, if not frequently, review the substantive merits of a business decision. If a plaintiff rebuts the presumption of the business judgment rule by showing a violation of fiduciary duty, the burden shifts to the defendants to prove the entire fairness of the transaction.[217] "Under the entire fairness standard of judicial review, the defendant directors must establish to the *court's* satisfaction that the transaction was the product of both fair dealing *and* fair price."[218] This requires the defendant to prove that the transaction was fair, and the court to review the substance of the transaction.[219] It is apparent that the entire fairness standard is predicated on confidence that courts, when necessary, can adequately perform review and monitoring functions, and they can and do inject themselves into corporate governance.

B. Political Economy of Lost Profit

An alternative economic-based theory explains that the pure economic loss rule embodies a broad political and philosophical view of economic organization and production.[220] This theory completes the conception of the duty of care and the business judgment rule, and it requires unpacking. It begins by categorizing business risk into two types: Risk to production assets, which is the potential loss of a factor of production; and risk to outcome, which is the potential loss of production.[221] The theory states that tort law does and should protect production assets from negligent harm, but it does not and should not protect against bad outcomes per ex post redistribution of profit and loss.[222] The theory reconciles the pure and the consequential economic loss rules.[223] In stating inverse propositions—economic loss flowing from physical loss is recoverable but an adverse economic outcome alone is not—the two rules express a unified proposition:

217 Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 361 (Del. 1993).

218 *Id.*; *see* Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261, 1279–80 (Del. 1988); Weinberger v. UOP, Inc., 457 A.2d 701, 710–11 (Del. 1983).

219 *Cede*, 634 A.2d at 371; *see* Block et al., *supra* note 4, at 491 ("This fairness standard is an exacting standard, requiring rigorous judicial scrutiny of the transaction with regard to both 'fair dealing' and 'fair price.'").

220 *See* Rhee, *supra* note 22, at 78–85.

221 *Id.* at 52.

222 *Id.* at 53, 86.

223 If a plaintiff's person or property has been injured, consequential economic loss is recoverable. *Id.* at 49–50.

The law promotes the goal of economic production by recognizing an economic loss claim when a production asset is harmed; at the same time, it preserves the condition necessary to pursue enterprise, which is uncertainty of market outcomes, by not redistributing profit and loss upon bad outcomes.

The pure economic loss rule must be contextualized to the theory of uncertainty and profit.[224] In the absence of uncertainty, there is perfect information, meaning costless communication of all information relevant to value among all members of society.[225] Production is in perfect sync with wants and needs; supply and demand are at perfect equilibrium. Perfect competition would ensure that the marginal cost of a production input is priced at the marginal benefit such that there is no profit. All economic exchanges can only take place at one price.[226] Division of labor and specialized risk taking by entrepreneurs lose their meaning because there would be no need for such market functions. The concept of profit would disappear,[227] and so too would firms since perfect information would obviate the need for price discovery among factors of production.[228]

Of course, perfect competition is fantasy. Information is imperfect and knowledge is incomplete.[229] The outcomes of most business decisions are uncertain because all future states of outcome cannot be known.[230] The production function of any enterprise is fraught with uncertainty.[231] Uncertainty is the condition precedent to profit,[232]

224 The relationship between uncertainty and profit was studied by Frank Knight. FRANK H. KNIGHT, RISK, UNCERTAINTY AND PROFIT (Dover ed. 2006); *see also* PETER L. BERNSTEIN, AGAINST THE GODS 219 (1996) ("*Risk, Uncertainty and Profit* is the first work of any importance, and in any field of study, that deals explicitly with decision-making under conditions of uncertainty.").

225 KNIGHT, *supra* note 224, at 78, 86.

226 *Id.* at 82.

227 *See id.* at 127 ("[I]t will be evident to anyone with a rudimentary understanding of economic processes and analysis that profit (always in the sense of pure profit) would be absent under the conditions of equilibrium with 'perfect competition' . . . .").

228 *See* R.H. Coase, *The Nature of the Firm*, 4 ECONOMICA 386, 390 (1937) ("The main reason why it is profitable to establish a firm would seem to be that there is a cost of using the price mechanism. The most obvious cost of 'organising' production through the price mechanism is that of discovering what the relevant prices are.").

229 KNIGHT, *supra* note 224, at 199, 259.

230 *Id.* at 231.

231 *Id.* at 237–38.

232 "The presence of true profit, therefore, depends on an absolute uncertainty in the estimation of the value of judgment, or on the absence of the requisite organization for combining a sufficient number of instances to secure certainty through consolidation." *Id.* at 285.

because profit is "a margin of error in calculation on the part of the non-entrepreneurs and entrepreneurs who do not force the successful entrepreneurs to pay as much for productive services as they could be forced to pay."[233] Thus, uncertainty is *the* vital element in an economy based on market exchange.

The pure economic loss rule arises out of this reality. Since exposure to business risk *defines* the engagement of enterprise, recovery for pure economic loss would distort outcomes of competition under Knightian uncertainty and conflict with a commitment to a political economy based on market competition, risk taking, and innovation. Corrective legal action is not required when occurrences of economic loss are not a failure of precaution but are instead a natural, inevitable market condition. Thus, the pure economic loss rule is a judicial acknowledgement of and commitment to a market economy, its preconditions, and the structure of our political economy.[234]

The application of the production theory to the business judgment rule is apparent. Profit is possible only in a condition of uncertainty, and it is achieved in many instances because of counterparty error. As Bishop suggested, "negligence" in business frequently results in no net social cost, and instead errors produce the winners and losers of market competition.[235] With imperfect information as the operative condition, bad outcomes in the course of repeated transactions of a corporate going concern are inevitable. Courts have long recognized the nature of business risk and loss, and the inevitability of losses:

> The proprietor buys, is liable for purchases, and assumes risks and profits. There are, as is true of many concerns, some which result in failure. Injudicious locations, excessive capitalizations, have contributed, now and again, to brief careers. Mismanagement, fires, rivalry, add to the causes. Businesses come and go, and losses are inevitable. A business is without constitutional protection against the hazards of competition.[236]

Inevitable accidents or losses are not considered the product of negligence. By refusing to correct bad outcomes, courts are respect-

233 *Id.* at 284.

234 Rhee, *supra* note 22, at 78.

235 *See* Bishop, *supra* note 21 and accompanying text.

236 State v. Chisesi, 175 So. 453, 459 (La. 1937) (quoting State v. Old Tavern Farm, 133 Me. 468, 476 (1935) (internal quotation marks omitted); *see also* Rowland v. Old Dominion Bldg. & Loan Ass'n, 18 S.E. 965, 966 (N.C. 1894) ("Losses, inevitable in every business, will occur."); Eagles Nest v. Ridinger, 684 S.E.2d 163, 167 (N.C. Ct. App. 2009) ("We observe that investing cash in a business does not guarantee a profit for the investor.").

ing and preserving the essential market conditions in which the corporation and its constituencies transact. There is a larger economic philosophy beneath the business judgment rule.

Here again, the theories of pure economic loss lurk beneath the commonly cited instrumental policy reasons. In *Joy v. North*,[237] Judge Ralph Winter explains that

> because potential profit often corresponds to the potential risk, it is very much in the interest of shareholders that the law not create incentives for overly cautious corporate decisions. Some opportunities offer great profits at the risk of very substantial losses, while the alternatives offer less risk of loss but also less potential profit. Shareholders can reduce the volatility of risk by diversifying their holdings. In the case of the diversified shareholder, the seemingly more risky alternatives may well be the best choice since great losses in some stocks will over time be offset by even greater gains in others. Given mutual funds and similar forms of diversified investment, courts need not bend over backwards to give special protection to shareholders who refuse to reduce the volatility of risk by not diversifying. A rule which penalizes the choice of seemingly riskier alternatives thus may not be in the interest of shareholders generally.[238]

Similarly, in *In re Caremark*, Chancellor William Allen explained that

> [t]he corporate form gets its utility in large part from its ability to allow diversified investors to accept greater investment risk. If those in charge of the corporation are to be adjudged personally liable for losses on the basis of a substantive judgment based upon what an [sic] persons of ordinary or average judgment and average risk assessment talent regard as "prudent" "sensible" or even "rational", such persons will have a strong incentive at the margin to authorize less risky investment projects.[239]

These passages make two key points. Risky decisions produce a social gain (and not a social loss), and the business judgment rule incentivizes risk averse directors to take risks by shielding them from unfair and disproportionate liability.[240]

These instrumental policy arguments are compelling. They go a long way toward explaining the business judgment rule. However,

237 Joy v. North, 692 F.2d 880 (2d Cir. 1982).

238 *Id.* at 886 (footnotes omitted).

239 *In re* Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 967–68 n.16 (Del. Ch. 1996).

240 Eisenberg, *supra* note 4, at 444. Directors bear the full costs of any personal liability, but receive only a fraction of the gain from risky decisions. ALLEN ET AL., *supra* note 5, at 243. "Liability under a negligence standard therefore would predictably discourage officers and directors from undertaking valuable but risky projects." *Id.*

standing on their own, they are subject to criticism. For instance, one can plausibly argue that in business there are good and bad risks. While we want directors to take risks, society does not want too much risk taking, which can also destroy value.[241] A reasonable response to the risk-incentive argument is that good risk taking should be encouraged and bad risk taking should be deterred. This is done in torts to regulate conduct. Arguably there may be a role for courts to deter bad decision-making by imposing liability. One can also plausibly argue that while shareholders can diversify away specific-firm risk, a rule of liability can reduce systemic market risk by incentivizing more prudent risk taking across the entire portfolio of firms (just the way that the tort system imposes a standard of care that enhances safety across society). Since liability acts as a deterrent, the question still remains: Why should the courts not have a say in terms of the quality of the board's decisions vis-à-vis the quality of the decision-making procedure?[242] The issue comes back to empirical question of whether the judicial process is in fact an imperfect monitor of bad decisions.

Rather than focusing on the instrumental question of the efficacy of the judicial process, we should instead consider risk taking in a broader light. Business risk, which includes the risk of bad decisions, is part and parcel with a market economy. Uncertainty and profit are conjoined twins. In an efficient market, one must take risk to achieve return. If so, the business judgment rule is a judicial recognition that financial harms to corporations are expected as an essential aspect of partaking in enterprise risk. That being the case, bad risk taking should not be considered a civil "wrong." In other words, a board does not have a *duty* to the corporation with respect to economic loss from bad or negligent decisions.

A case that hints at this broader concept is *Smith v. Brown-Borhek Co.*[243] There, the board extended more than $650,000 of credit to a single customer.[244] This amount constituted eighty percent of the corporation's receivables and sixty-three percent of its assets, an

241 For instance, the main reason why fiduciary duty shifts to creditors when a firm is insolvent is that shareholders are incentivized to take too much risk. *See, e.g.*, Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc'ns Corp., 17 DEL. J. CORP. L. 1099, 1155 & n.55 (Del. Ch. 1991).

242 "[I]f judicial decisionmaking could flawlessly sort out sound decisions with unfortunate outcomes from poor decisions, and directors were confident that there was no risk of hindsight-based liability, the case for the business judgment rule would be substantially weaker." BAINBRIDGE, *supra* note 1, at 261.

243 Smith v. Brown-Borhek Co., 200 A.2d 398 (Pa. 1964).

244 *Id.* at 399.

imprudent concentration of financial risk in the firm's balance sheet.[245] The board knew or should have known that the customer's liabilities exceeded assets, and thus posed a substantial credit risk. It exercised bad judgment when it concentrated risk so heavily on one client. The customer defaulted on the credit, and the company was forced to write off a substantial loss.[246] The court concluded that the conditions to applying the business judgment had been satisfied, and thus held that there was no liability.[247] The explanation for the business judgment rule is informative:

> The meaning and application of the "prudent man rule" (a) in the field of a testamentary or inter vivos trust, containing relatively few securities and (b) in the business or banking world are very different. For example, in the banking business bad loans or sour investments or unsuccessful business transactions are part and parcel of that business and are charged off every year . . . . *In the business world of profit and loss, which is often popularly described as the profit system, it is too often forgotten that all businesses do not flourish, nearly every business has some losses and some bad accounts, and many insolvencies and bankruptcies frequently occur even in these prosperous times.*[248]

In the "profit system" of a market economy, economic losses of a going concern are expected and unavoidable in the course of repeated transactions. The definition of negligence cannot include inevitable outcomes that must result from the undertaking. Thus, the political economic underpinning of pure economic loss provides the theory for the rule of no duty to prevent economic loss upon the affirmative assumption of care in the corporate context.

C. Shareholder Loss and Privity

The above Parts have shown that, as between the corporation and its directors, a negligent error or mistake causing losses is no "wrong" when the board has complied in good faith with its obligation to care for the corporation. But is it a wrong as to shareholders? After all, as residual claimants, they are the first bearers of economic loss. As a matter of logic, if the scope of duty to the corporation does not encompass negligently inflicted economic loss on the corporation, the duty running to the shareholder should be no more. That should settle the matter, for as an economic and legal proposition the interest of the corporation always trumps the pecuniary interest of share-

245 *Id.*
246 *See id.* at 399.
247 *See id.* at 403.
248 *Id.* at 401 (emphasis added) (footnote omitted).

holders. Logic aside, a separate tort analysis under the privity doctrine provides the theoretically correct answer that shareholders have no cause of action for negligently caused economic losses.

Courts have frequently commented that "the directors owe fiduciary duties of care and loyalty to the corporation *and* its shareholders."[249] This formulation implies that the duty owed to shareholders ranks *pari passu* with that owed to the corporation. But this is not the case. The board's duty to the corporation is unwavering and unqualified,[250] but its duty to shareholders is not so absolute. For example, in takeovers, actual shareholder preference is no basis to impose liability if the board disagrees with it.[251] In insolvency, the board's fiduciary duty is no longer to shareholders, but pivots to creditors.[252] When shareholders threaten the interest of the corporation, the board may take hostile actions against them to advance the corporation's interest.[253] Ultimately, directors owe their fiduciary duty to the corporation as a legal entity.[254] Shareholders are one group of multiple constituencies, including creditors, employees, customers, and suppliers, and by virtue of their residual claim they best stand to represent the corporation's interest in a derivative suit.[255] Thus, we can say that the duty running from a director to the shareholder is not direct, but flows through the corporation.

249 Paramount Commc'ns Inc. v. QVC Network Inc., 637 A.2d 34, 43 (Del. 1994) (emphasis added). The same formulation is seen elsewhere. Alabama By-Products Corp. v. Cede & Co., 657 A.2d 254, 265 (Del. 1995); Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261, 1280 (Del. 1988).

250 *Cf.* Robert J. Rhee, *Fiduciary Exemption for Public Necessity: Shareholder Profit, Public Good, and the Hobson's Choice During a National Crisis*, 17 GEO. MASON L. REV. 661, 714 (2010) (arguing that, in times of national crisis, there should be a fiduciary exemption when a director acts on behalf of the public interest).

251 "That many, presumably most, shareholders would prefer the board to do otherwise than it has done does not . . . afford a basis to interfere with the effectuation of the board's business judgment." Paramount Commc'ns Inc. v. Time Inc., 15 DEL. J. CORP. L. 700, 750 (Del. Ch. 1989).

252 "It is well settled that directors owe fiduciary duties to the corporation. When a corporation is *solvent*, those duties may be enforced by its shareholders, who have standing to bring *derivative* actions on behalf of the corporation because they are the ultimate beneficiaries of the corporation's growth and increased value." N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla, 930 A.2d 92, 101 (Del. 2007).

253 *See* Orban v. Field, 23 DEL. J. CORP. L. 335 (Del. Ch. 1997).

254 ALLEN ET AL., *supra* note 5, at 294. Delaware leans toward the entity model of the corporation, and the corporation as a legal entity is ultimately the person to whom the board owes its duty. *See* William T. Allen et al., *The Great Takeover Debate: A Meditation on Bridging the Conceptual Divide*, 69 U. CHI. L. REV. 1067, 1079 (2002) ("Delaware law inclines towards the entity model.").

255 *Gheewalla*, 930 A.2d at 101.

The linearity of the contractual nexus among the board, the corporation, and the shareholder is important from the standpoint of legal duty. A quick review of seminal cases in tort law shows that the lack of a direct contractual privity precludes the finding of duty. As previously discussed, in *Robins Dry Dock*, there was a linear contractual nexus among the dry dock, the ship owner, and the charterer.[256] Yet, there was a no tort duty from the dry dock to the charterer because "[t]he injury to the propeller was no wrong to the [charterer] but only to those to whom it belonged."[257] In *H.R. Moch Co. v. Rensselaer Water Co.*,[258] a city resident suffered losses from a fire when the water company provided insufficient water pressure under a contract with the city.[259] Chief Justice Cardozo ruled that the linear contractual link among the water company, the city, and its residents does not create a tort duty toward the residents.[260] In the seminal case of *Ultramares Corp. v. Touche*,[261] an accountant negligently certified its client's balance sheet, and, relying upon the certification, a creditor extended credit.[262] Chief Justice Cardozo dismissed the lawsuit for lack of duty under the privity doctrine.[263] Note that in each of these cases the plaintiff was connected to the tortfeasor in a linear "nexus of contract."

We can apply the concept of privity and duty to corporation law. The existence of a "nexus of contracts" among the board, the corporation, and the shareholder does not inexorably lead to the conclusion that the board has a legal duty to prevent negligently inflicted economic loss to shareholders. Liability does not extend that far under tort analysis. Here again, the tort analogy holds to yield the correct results seen in corporation law.

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256 Robins Dry Dock & Repair Co. v. Flint, 275 U.S. 303, 307 (1927).

257 *Id.* at 308.

258 H.R. Moch Co. v. Rensselaer Water Co., 159 N.E. 896 (N.Y. 1928).

259 *Id.* at 896–97.

260 *Id.* at 899.

261 Ultramares Corp. v. Touche, 174 N.E. 441 (N.Y. 1931).

262 *Id.* at 442. *See generally* Jay M. Feinman, *Liability of Accountants for Negligent Auditing: Doctrine, Policy, and Ideology*, 31 FLA. ST. U. L. REV. 17 (2003) (describing the law for auditor liability).

263 *Touche*, 174 N.E. at 447. He reasoned that a finding of duty to the creditor would "expose accountants to a liability in an indeterminate amount for an indeterminate time to an indeterminate class." *Id.* at 444. A similar reasoning is used in *H.R. Moch*: "A promisor will not be deemed to have had in mind the assumption of a risk so overwhelming for any trivial reward." 159 N.E. at 898. Note the similarity of this reasoning to the frequently cited justification of the business judgment rule on the ground that directors would not undertake their obligation given the cost-benefit of such a position. *See supra* note 240 and accompanying text.

IV. Implications of a Corrected Tort Analogy

A. *The Role of Tort Principles in Corporate Law*

The implication of this Article is that principles and theories of tort law play an important role more broadly in corporation law. The duty of care and the business judgment rule are not the only imports of tort principles into corporation law. The idea of a civil wrong and the theories supporting it are powerful analytic tools.[264] Consider the following examples of doctrines of corporation law that can be viewed through the tort prism.

The fiduciary duty of loyalty prohibits a director from engaging in conflict of interest transactions and otherwise expropriating corporate assets. Principles of agency mandate a fiduciary duty of loyalty,[265] but the core prohibition is also based on the tort concept that conversion and fraud are civil wrongs.[266]

The doctrine of veil piercing, a judge-made law, can be understood as a prohibition against fraud by controlling shareholders. Ex post undercapitalization alone is not a basis for piercing the corporate veil since the invocation of the rule of limited liability occurs only when a firm is undercapitalized after the fact. Instead, while individual jurisdictions may differ on the precise standard, a core requirement of veil piercing is some sort of fraudulent behavior constituting a wrong in the eyes of the court.[267]

In the realm of takeover law, the tort law of self-defense informs Delaware's standard for reviewing the appropriateness of a board's adoption of antitakeover defenses. Under *Unocal Corp. v. Mesa Petroleum Co.*,[268] the target has the burden to establish that the board reasonably perceived that the hostile takeover bid was a threat to the

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264 *See* Kahan & Rock, *supra* note 11, at 1327 (noting that a breach of fiduciary duty may be considered as a "civil wrong").

265 *See* Restatement (Third) of Agency § 8.01 (2006) ("An agent has a fiduciary duty to act loyally for the principal's benefit in all matters connected with the agency relationship.").

266 "Classic conflict of interest transactions and expropriation of assets find their doctrinal roots, in part at least, in the civil wrongs of conversion and fraud." Rhee, *supra* note 250, at 711.

267 *See* Bainbridge, *supra* note 1, at §4.3(A); Easterbrook & Fischel, *supra* note 1, at 58–59; *see also, e.g.*, Carte Blanche (Singapore) Pte., Ltd. v. Diners Club Int'l, Inc., 2 F.3d 24, 26 (2d Cir. 1993) (allowing corporate veil to be pierced "to prevent a fraud or other wrong"); Perpetual Real Estate Servs., Inc. v. Michaelson Props. Inc., 974 F.2d 545, 548 (4th Cir. 1992) (same); Associated Vendors, Inc. v. Oakland Meat Co., 26 Cal. Rptr. 806, 816 (Cal. Dist. Ct. App. 1962) (same); Zaist v. Olson, 227 A.2d 552, 558 (Conn. 1967) (same).

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

corporation, and the takeover defensive measure adopted was reasonable in response to the threat.[269] The concept embodied in this standard is seen in the tort standard for self-defense, which provides defensive measures cannot be "in excess of that which the actor correctly or reasonably believes to be necessary for his protection."[270]

The laws of corporation and torts obviously intersect at the rule of limited liability. The rule influences the animating principles of tort law.[271] Incomplete compensation to tort creditors is an unfortunate outcome of the operation of an efficient rule.[272] To correct this problem, while at the same time enforcing limited liability, we can apply the theory of enterprise liability to the entire class of limited liability business organizations. Thus, limited liability can be "bonded" by a mandatory compensation fund that would deliver more compensation to tort victims while being neutral to efficiency considerations of limited liability.[273]

Lastly, section 102(b)(7) of the Delaware General Corporation Law (DGCL) is a clear example of the tort foundation of the fiduciary duty. This section provides that a corporate charter may provide 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."[274] This provision permits a corporation to opt out of director liability for a breach of the duty of care.[275]

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269 *Id.* at 954–55. In *Unocal*, the court modified the ordinary operation of the business judgment rule. *Id.* at 954. Because the threat of board self-perpetuation is so substantial in the takeover context, the board's adherence to is fiduciary duty "calls for judicial examination at the threshold before the protections of the business judgment rule may be conferred." *Id.* The court further suggested that the business judgment rule would not protect the board when it erects unreasonable defensive measures. *Id.* at 955.

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

271 *See* Henry Hansmann & Reinier Kraakman, *Toward Unlimited Shareholder Liability for Corporate Torts*, 100 YALE L.J. 1879, 1916–23 (1991); David W. Leebron, *Limited Liability, Tort Victims, and Creditors*, 91 COLUM. L. REV. 1565, 1612 (1991).

272 *See* Rhee, *supra* note 13, at 1446–50.

273 *See id.* at 1450–56.

274 DEL. CODE ANN. tit. 8, § 102(b)(7) (2011); *see* MODEL BUS. CORP. ACT § 2.02(b)(4) (2011) (adopting a similar exculpation provision). The legislature enacted this section in the wake of *Smith v. Van Gorkom*. *See* Emerald Partners v. Berlin, 787 A.2d 85, 90 (Del. 2001); Malpiede v. Townson, 780 A.2d 1075, 1095 (Del. 2001). Most Delaware public corporations have passed charter amendments incorporating an exculpation clause under section 102(b)(7). *See In re* Walt Disney Co. Derivative Litig., 907 A.2d 693, 752 (Del. Ch. 2005); Roberta Romano, *Corporate Governance in the Aftermath of the Insurance Crisis*, 39 EMORY L.J. 1155, 1160–61 (1990).

275 *See* Robert C. Clark, *Contracts, Elites, and Traditions in the Making of Corporate Law*, 89 COLUM. L. REV. 1703, 1704 (1989); Jonathan R. Macey, *Fiduciary Duties as*

Contractarian scholars have touted section 102(b)(7) as a clear example of corporation law's grounding in contracts.[276] Yet, this contractarian explanation does not pass muster upon a closer examination from the perspective of tort law.

Section 102(b)(7) is in the nature of an affirmative defense.[277] It is a waiver of liability and assumption of risk by the corporation for acts that would otherwise be a breach of the duty of care. Courts have recognized that in the course of commercial transactions, parties can contract for varying levels of care in the tort realm.[278] The validity of such waivers of liability depends on the legitimacy of the actual bargaining with an attention to coercion, adhesion, and asymmetric bargaining. Importantly, even when there has been actual bargaining and an informed waiver, courts invalidate contracts based on important public policy concerns.[279] Under tort law, the freedom to contract is constrained by public policy.[280]

Section 102(b)(7) is best understood as a waiver of liability under a tort framework. It allows the exculpation of a director's personal liability for money damages, but there are important public policy prohibitions that limit freedom of contract. The violation of a duty of care can still result in equitable relief[281] such as injunction and rescis-

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Residual Claims: Obligations to Nonshareholder Constituencies from a Theory of the Firm Perspective, 84 CORNELL L. REV. 1266, 1271–72 (1999); Rock, *supra* note 82, at 1012. *But see* Blair & Stout, *supra* note 4, at 1791 n.150 (rejecting characterization that section 102(b)(7) permits opting out of duty of care "because the provision does not excuse directors from using care—it merely relieves them of personal liability for damages for failing to do so").

276 "Arguably, the most important change created by *Van Gorkom* is the duty of care opt-out provision of section 102(b)(7) and the demonstration that such a contractarian approach to corporate governance is workable." 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, 281–82 (2006); *see also* Arthur B. Laby, *The Fiduciary Obligation as the Adoption of Ends*, 56 BUFF. L. REV. 99, 125 (2008) (noting that contractarian scholars point to section 102(b)(7) as a prime example of the theory of corporate contract).

277 Emerald Partners v. Berlin, 726 A.2d 1215, 1223–24 (Del. 1999).

278 *See generally, e.g.*, Anderson v. Erie R.R. Co., 119 N.E. 557 (N.Y. 1918) (finding no liability upon express waiver given in consideration for reduced fare); Manning v. Brannon, 956 P.2d 156 (Okla. Civ. App. 1997) (finding no liability for express waiver based upon arms-length transaction).

279 *See* E. ALLAN FARNSWORTH, CONTRACTS 313–51 (4th ed. 2004) (discussing the principle).

280 *See, e.g.*, Tunkl v. Regents of Univ. of Cal., 383 P.2d 441, 441–42 (Cal. 1963) ("[A]n agreement between a hospital and an entering patient affects the public interest and . . . the exculpatory provision included within it must be invalid under [California Civil Code].").

281 ALLEN ET AL., *supra* note 5, at 260–61.

sion. Importantly, the exculpation provision does not extend to breach of loyalty, bad faith, intentional misconduct, or self-interested transactions.[282] Such broad waivers would clearly violate public policy.[283] Thus, even if a corporation and its board properly follow the procedures set forth in corporation law and institute a complete elimination of fiduciary duty in the absence of a legislative mandate, such an act would be void as a matter of public policy.

The exculpation provision of corporation law is as much an illustration of the *limits* of the purely contractual view of corporate governance. This is made clear when we compare Section 102(b)(7) with its counterpart in the Delaware Limited Liability Company Act (DLLCA). Section 1101 of the DLLCA permits fiduciary duty to be "*eliminated* by provisions in the limited liability company agreement; provided, that the limited liability company agreement may not eliminate the implied contractual covenant of good faith and fair dealing."[284] Compare, then, Section 1101 with Section 102(b)(7), which provides that the corporate charter cannot eliminate the duty of loyalty, the obligation to act in good faith, the obligation to refrain from intentional misconduct or knowing violation of the law, liability for unlawful stock purchase or payment of dividends, and liability for transactions from which the director derived an improper personal benefit.[285] The policy of the DLLCA is "to give the maximum effect to the principle of freedom of contract,"[286] but the same cannot be said for the DGCL as to fiduciary waivers.

It is fair to say that exculpation provisions of corporation law would never go so far as to allow elimination of fiduciary duties. While members of an LLC may well be served by a near complete freedom of contract as to fiduciary duty, even diehard contractarian scholars would probably have qualms about permitting the elimination of fiduciary duty in corporation law. Unlike the actual con-

282 *See* DEL. CODE ANN. tit. 8, § 102(b)(7) (2011); MODEL BUS. CORP. ACT § 2.02(b)(4) (2011).

283 *Cf.* Bainbridge, *supra* note 4, at 116 ("[T]he business judgment rule has never protected directors who commit fraud or self-dealing.").

284 DEL. CODE ANN. tit. 6, § 18-1101(c) (emphasis added). The "contractual" emphasis makes clear that the covenant of good faith and fair dealing must relate to a specific, bargained for contractual term in the operating agreement, as opposed to a more amorphous, judicially malleable concept of good faith.

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

286 DEL. CODE ANN. tit. 6, § 1101(b). Delaware is not alone in permitting the elimination of fiduciary duty. A substantial number of states also permit contractual elimination. *See* 1 LARRY E. RIBSTEIN & ROBERT R. KEATINGE, RIBSTEIN AND KEATINGE ON LIMITED LIABILITY COMPANIES 524–25 (2d ed. 2011) (listing eighteen states as permitting full power to waive fiduciary duty).

tracting that takes place among members in an LLC,[287] which operates very much like a partnership, the "nexus of contracts" is a metaphor in corporation law first used by economists to describe a bundle of economic rights among corporate constituents.[288] "Contracting" occurs on various levels of abstraction.[289] More importantly, the public interest in the proper working of the modern public corporation is many orders more significant than the interest in smaller business entities, and as such corporation law is substantially tinged with considerations of public policy. Courts and legislatures are well aware of this fact. There is no doubt that the permissible elimination of fiduciary duty, something that would be in the best self-interest of directors and officers, would be disastrous for corporate enterprises.[290] Seen as a waiver of liability for a breach of duty, Section 102(b)(7) is a clear example of the tort foundation of corporation law.

As the above discussion shows, it is clear that tort principles are seen in various corners of corporate law. And, as explained in Part II, the application of tort principles and theories explains the nature of the fiduciary duty of care and the business judgment rule. However, the distinction between torts and contracts is not so clear. Some tort problems can be viewed as hypothetical contract problems,[291] and a contract analysis of the terms and conditions is dispositive with respect to allocating liability among market participants. This raises the question: Is there a meaningful analytical significance between the prevailing contractarian view of corporate law and a corrected tort analogy, or is the issue simply academic? In most cases, regardless of whether the standard of care is said to derive ultimately from contracts or torts, the end is the same. We reach the same Coasean result achieved by respecting the bargain that would have been struck but for the impediment of transaction costs and, in the case of corporate law, the impractical reality that the corporate entity cannot bargain for

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287 *See* Ribstein, *supra* note 165, at 37 (suggesting that LLCs "have real contracts" unlike corporations).

288 *See* Jensen & Meckling, *supra* note 121, at 310. *See generally* Coase, *supra* note 228.

289 *See* Ribstein, *supra* note 165, at 37–38 (suggesting that "contracting" in the corporation is only "hypothetical").

290 For a discussion of the collapse of Enron and how it was attributable to the board's failure to monitor the corporation and a poisonous web of conflict of interest among its executives and professional advisers, see generally Salter, *supra* note 203 (describing the origin and legacy of Enron's collapse).

291 Rodi Yachts, Inc. v. Nat'l Marine, Inc., 984 F.2d 880, 882 (7th Cir. 1993); *see also supra* note 122.

itself.[292] However, the distinction matters because a tort perspective provides greater leeway in considering the normative implications of fiduciary duty and board liability.

The difference in perspectives can result in a narrow band of cases where a tort analysis can yield more flexible and better results when societal wealth is the maximand.[293] An interesting case illustrating the point arose during the financial crisis of 2007–2009. On the same day that Lehman Brothers filed for bankruptcy in September 2008, Bank of America and Merrill Lynch announced their merger.[294] Much has been written about this merger in the popular press and in the academic literature, and a detailed recitation of the facts is unnecessary.[295] The salient facts for the purpose here are these: In the midst of the financial crisis, Bank of America agreed to acquire Merrill Lynch.[296] The board approved the deal knowing that Bank of America had conducted due diligence on Merrill Lynch for only about 30 hours.[297] Merrill Lynch was a multi-billion dollar firm and one of three largest independent investment banks at the time.[298] Suffice to say that its businesses operations, including its trading activities, were incredibly complicated, made exponentially more complicated by an ongoing global financial crisis including the concurrent demise of Lehman Brothers. Considering only Bank of America's decisionmaking, the procedure surrounding the acquisition was clearly flawed and grossly negligent.[299] The argument that the board satisfied its duty of care when it approved the merger defies credibility.[300]

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292 *See* Coase, *supra* note 228.

293 *See* EASTERBROOK & FISCHEL, *supra* note 1, at 37 (arguing societal wealth is the maximand).

294 *See* Rhee, *supra* note 250, at 664–96 (describing the events of the merger).

295 *See generally id.*; GREG FARRELL, CRASH OF THE TITANS (2010).

296 Rhee, *supra* note 250, at 665.

297 *Id.* at 678–79.

298 *See* Andrew Ross Sorkin, *Lehman Files for Bankruptcy; Merrill Is Sold*, N.Y. TIMES, Sep. 15, 2008, at A1, *available at* http://www.nytimes.com/2008/09/15/business/15lehman.html?pagewanted=all&_r=0.

299 Rhee, *supra* note 250, at 678.

300 "To suggest that the Bank fully assessed Merrill within a matter of a few hours during extraordinary circumstances is a bridge too far." *Id.* at 682. Subsequently, Bank of America settled federal securities class action based on improper disclosure surrounding the Merrill Lynch acquisition for $2.43 billion. Jessica Silver-Greenberg & Susanne Craig, *Bank of America Settles Suit Over Merrill for $2.43 Billion*, N.Y. TIMES, Sep. 28, 2012, at A1, *available at* http://dealbook.nytimes.com/2012/09/28/bank-of-america-to-pay-2-43-billion-to-settle-class-action-over-merrill-deal/.

Despite the clear violation of the fiduciary duty of care, the Merrill Lynch acquisition raises an interesting hypothetical: Suppose the board approved the deal and rescued Merrill Lynch, despite the clear procedural flaws in due diligence, because the board felt compelled to assist the government and the public during an extraordinary public crisis by rescuing a financially troubled Merrill Lynch at the cost of financial harm to Bank of America. In this case, absent statutory authority or mandate,[301] a contractarian analysis would rely on the principal-agent contract, under which an agent clearly cannot intentionally harm the principal; here, corporate value would be preserved while societal wealth would diminish in a far greater sum. On the other hand, a tort-based analysis may yield a different wealth maximizing outcome. Under tort principles, intentional harm that would ordinarily be a breach of duty may be excused when public necessity mandates the result.[302] Whereas under a contractarian analysis there would be breach of duty and the imposition of liability, under a flexible tort analysis certain conduct that would otherwise be a breach of duty may be given a safe harbor when social wealth is the maximand and the board's action advanced that goal.

Therefore, while in most cases, the analytical frameworks of torts or contracts produce the same results, there are cases where the framework matters. Differences in normative value judgments, if permitted to be expressed, may yield this divergence.

B. *Doctrinal Development and the Central Role of Courts*

An orientation of the duty of care and the business judgment rule as rules of duty—and taking the concept of duty seriously as a theoretical matter—leads to an important implication. Duty and its scope are legal questions requiring an inquiring court.[303] This fundamental point has been challenged and it requires analysis.

301 In fact, there is statutory authority for boards to provide public assistance to the government. *Id.* at 704–09 (citing DEL. CODE ANN. tit. 8, § 122(12) (2009) and MODEL BUS. CORP. ACT § 3.02(14) (2003)). "[S]ection 122(12) empowers a corporation 'to transact any lawful business which the corporation's board of directors shall find to be in aid of governmental authority.'" *Id.* at 704 (quoting DEL. CODE ANN. tit. 8, § 122(12)).

302 *See id.* at 707–15 (discussing necessity and proposing a fiduciary exemption during a public crisis).

303 "The formulation of the duty of loyalty and duty of care involves questions of law which are, of course, subject to *de novo* review by this Court." Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 360 (Del. 1993); *cf.* RESTATEMENT (SECOND) OF TORTS § 328B (1965) ("[T]he court determines . . . whether such facts give risk to any

Most notably, Stephen Bainbridge has argued that the business judgment rule is an abstention doctrine, and not a standard of liability requiring a substantive judicial review of board decisions.[304] The abstention theory of the business judgment rule is highly dependent upon an acceptance of Bainbridge's theory of director primacy, which states that the central problem in corporation law is the tension between authority and accountability.[305] Authority and accountability are antithetical because the power to hold to account is ultimately the power to decide.[306] The business judgment rule is the principal mechanism by which corporation law resolves that tension.[307] The business judgment rule is a judicial abstention doctrine, and it "thus builds a prophylactic barrier by which courts pre-commit to resisting the temptation to review the merits of the board's decision."[308] Judicial review should be the exception rather than the rule. This contemplates judicial reticence, but leaves open the possibility of judicial intervention in an appropriate, limited set of circumstances. "If the business judgment rule is treated as a standard of liability, rather than as an abstention doctrine, judicial intervention readily could become the norm rather than the exception."[309] Framed in this way, Bainbridge suggests that the business judgment rule is a normative limitation on the exercise of the court's authority.

The abstention theory is problematic in several ways. First, if we are to construe the reference to an abstention doctrine strictly rather than as a rhetoric device, none of the traditional abstention doctrines in matters of jurisdiction and judicial comity, the doctrinal space where abstention is seen in actual practice, apply to the issues in cor-

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legal duty on the part of the defendant [and] the standard of conduct required of the defendant by his legal duty . . . .").

304 Bainbridge, *supra* note 4, at 87–88; *accord* Johnson, *Modest*, *supra* note 4, at 631 ("Properly understood, the business judgment rule is simply a policy of judicial *non-review*.").

305 Bainbridge, *supra* note 4, at 86. For a more thorough development of the idea of the tension between authority and accountability, see generally Stephen M. Bainbridge, *Director Primacy in Corporate Takeovers: Preliminary Reflections*, 55 STAN. L. REV. 791, 807 (2002); Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547, 605 (2003). Others have expressed similar views on board authority and accountability. *See* Michael P. Dooley & E. Norman Veasey, *The Role of the Board in Derivative Litigation: Delaware Law and the Current ALI Proposals Compared*, 44 BUS. LAW. 503, 522 (1989) ("The power to hold to account is the power to interfere and, ultimately, the power to decide.").

306 Bainbridge, *supra* note 4, at 103.

307 *Id.* at 87.

308 *Id.* at 128.

309 *Id.* at 127.

poration law.[310] Second, abnegation of judicial authority conflicts with the essential role of courts in defining duty and determining liability. The business judgment rule cannot be an abnegation of power because its very existence arises from the exercise of judicial lawmaking.[311] The court's power to give deference must also mean the court's power to take it.[312]

Bainbridge does not go so far as to suggest that courts lack the power to opine on questions of business decisions. He properly acknowledges that the theory is not one of jurisdiction—ultimately it is the court's decision to "pre-commit" to not review the substance of a board's decision.[313] But he suggests that the purpose of the business judgment rule "is to prevent courts from even asking the question: did the board breach its duty of care?"[314] From a tort perspective, this is a non sequitur. It is axiomatic that duty is a question of law decided by courts.[315] If there is a common law-based imposition of duty, as there is in the Delaware scheme of fiduciary duty, the court must determine questions of duty and breach. The abstention theory is irreconcilably in tension with the fundamental principle that courts decide questions of duty and once a duty exists there must be a process to determine whether it has been breached (otherwise we would have an incoherent oxymoron in a form of a legal duty without enforceable obligation).

The business judgment rule does not accomplish protection of board decisions through judicial abnegation. Rather, the systematic outcomes of no liability are achieved because the business judgment rule reflects a reasoned judgment of courts on the nature of a wrong; they evince the exercise of judicial power, and not the relinquishment of it. As a statement on duty, the question of board liability is first a question of law, thus largely insulating disinterested directors from a

310 *See* Ann M. Scarlett, *A Better Approach for Balancing Authority and Accountability in Shareholder Derivative Litigation*, 57 U. KAN. L. REV. 39, 75–80 (2008). Scarlett argues that the qualified immunity provides a better model for the business judgment rule. *Id.* at 85–90. Broadly, immunity is a defense against torts. *See* W. PAGE KEETON ET AL., PROSSER AND KEETON ON THE LAW OF TORTS §§ 131–135 (5th ed. 1984).

311 *See supra* note 46 and accompanying text.

312 The court's deference is only that under the business judgment rule it will not "unreasonably" impose itself into the business and affairs of the corporation. Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 360 (Del. 1993).

313 Bainbridge, *supra* note 4, at 128.

314 *Id.* at 95.

315 *See generally, e.g.*, Widlowski v. Durkee Foods, 562 N.E.2d 967 (Ill. 1990) (holding that a finding of no duty by the court is permissible at motion to dismiss stage); Palsgraf v. Long Island R.R. Co., 162 N.E. 99 (N.Y. 1928) (finding, as a matter of law, that no duty existed).

factfinder's judgment.[316] As a legal question, however, duty is a malleable concept subject to the court's power to determine its existence and scope: courts can stretch it, contract it, or shape it as common law courts are prone to do with changing social, economic, and political circumstances resulting in incremental differences in normative value judgments over time.[317] Common law courts, and particularly Delaware courts, sitting in corporation law are not oblivious to these facts of judicial authority and the common law process.[318]

An example of how an inquiring court shapes the concept of duty and defines wrongs is the Delaware Supreme Court's decision in *Zapata Corp. v. Maldonado*.[319] There, an independent special litigation committee exercising its business judgment moved to dismiss a properly filed shareholder derivative suit.[320] The court rejected the use of the business judgment rule to the independent committee's decision, which would preclude judicial review of the decision.[321] It determined that the "risk in the realities of [the] situation," such as sympathy for fellow directors, justified "caution beyond adherence to the theory of business judgment."[322] The substantive business decision was not beyond the jurisdiction or the ken of the court, which can competently opine on the nature of fiduciary relationships and duties.[323] Accordingly, in determining whether to dismiss the case pursuant to the motion of the special litigation committee, the court adopted a two-part standard: First, "the [c]ourt should inquire into the independence and good faith of the committee;" second, "the [c]ourt should determine, *applying its own independent business judgment*, whether the motion should be granted."[324] *Zapata* is not fol-

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316 ALLEN ET AL., *supra* note 5, at 256.

317 *See* William L. Prosser, Palsgraf *Revisited*, 52 MICH. L. REV. 1, 15 (1953) ("These are shifting sands, and no fit foundation. There is a duty if the court says there is a duty . . . .").

318 *See* Marcel Kahan & Edward Rock, *Symbiotic Federalism and the Structure of Corporate Law*, 58 VAND. L. REV. 1573, 1610 (2005) ("Delaware corporate law may be the last vestige of the 19th century common law style in America."); E. Norman Veasey & 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, 1411 (2005) ("Delaware's common law process, which places case law at the forefront of corporate law, is the functional equivalent of judicial legislation.").

319 Zapata Corp. v. Maldonado, 430 A.2d 779 (Del. 1981).

320 *Id.* at 781.

321 *Id.* at 787.

322 *Id.*

323 *Id.* at 788.

324 *Id.* at 788–89 (emphasis added).

lowed in other jurisdictions.[325] Whether one agrees or not with the merit of the Delaware approach on this particular issue, the case shows how courts can and do shape the questions of duty and scope of duty. As the court concludes, "[u]nder our system of law, courts and not litigants should decide the merits of litigation."[326]

Another example of how the judicial process shapes the law of duty and breach is *Cede & Co. v. Technicolor, Inc.* There, the trial court per Chancellor Allen found a breach of the duty of care, but relying on *Barnes v. Andrews*[327] he ruled for the defendant on the ground that the plaintiff could not prove causation and injury.[328] The trial court rolled the concepts of duty, breach of duty, causation, and injury into the business judgment rule, requiring the plaintiff to show gross negligence, causation, and injury to overturn the presumption of the business judgment rule.[329] The Delaware Supreme Court rejected this expansion of the business judgment rule.[330] Properly characterizing *Barnes* as a tort case,[331] the court opined that the "tort principles of *Barnes* have no place in a business judgment rule standard of review analysis."[332]

Contrary to the seemingly blanket rejection of tort principles, the *Cede* court's ruling is on sound tort footing. The tort principle in *Barnes* was causation. It is a basic principle that questions of duty,

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325 *See* Auerbach v. Bennett, 393 N.E.2d 994, 996 (N.Y. 1979) (ruling that the substantive decision to dismiss the case is subject to the business judgment rule); *see also* Atkins v. Topp Comm, Inc., 874 So. 2d 626, 628 (Fla. Dist. Ct. App. 2004) ("The plain language of [the Florida statute] does not require *Zapata*'s second-step analysis."); Boland v. Boland, 31 A.3d 529, 538 (Md. 2011) ("[W]e shall adhere to the business judgment rule as applied in *Auerbach* . . . ."); *In re* UnitedHealth Group Inc. Shareholder Derivative Litig., 754 N.W.2d 544, 559 (Minn. 2008) ("Finding nothing in either our statutes or case law that compels the level of scrutiny contemplated in *Zapata*, and concluding that the reasoning of *Auerbach* is more persuasive, we adopt a test modeled on the *Auerbach* standard."); REVISED UNIFORM LIMITED LIABILITY COMPANY ACT § 905(e) (following the *Auerbach* approach for LLC's).

326 *Zapata*, 430 A.2d at 789 n.18 (quoting Maldonado v. Flynn, 413 A.2d 1251, 1263 (Del. Ch. 1980)).

327 *Barnes v. Andrews*, 298 F. 614 (S.D.N.Y. 1924); *see supra* Part II.A.

328 Cinerama, Inc. v. Technicolor, Inc., 17 DEL. J. CORP. L. 551, 561, 572–73 (Del. Ch. 1991).

329 *Id.* at 572. "Under the conventional (business judgment) approach . . . [a] plaintiff must show that director gross negligence is involved and must show as well that the stockholders were injured by that negligence." *Id.* (citing *Barnes*, 298 F.).

330 Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 370 (Del. 1993).

331 *Id.* at 370 ("*Barnes* [is] a tort action . . . ."); *see also Barnes*, 298 F. at 616 ("This cause of action rests upon a tort, as much though it be a tort of omission as though it had rested upon a positive act.").

332 *Cede*, 634 A.2d at 370 ("*Barnes*, a tort action, does not control a claim for breach of fiduciary duty.").

breach, causation, and injuries are separate inquiries.[333] This idea was famously memorialized in the debate between Cardozo and Andrews in *Palsgraf*.[334] The business judgment rule defines the standard of care, *i.e.*, the meaning of negligence, and with its presumption it places the burden of proof on the plaintiff to prove a wrong. In *Cede*, the plaintiff did so and thus overturned the rule's presumption.[335] That being the case, *Cede* rejected the trial court's attempt to encompass the concepts of duty, breach, causation, and injury in a single rule of law, which would have inordinately placed doctrinal stress on the rule itself.[336]

The inquiries of causation and injury have no place in an inquiry concerning duty and standard of care. Once a breach of fiduciary duty is shown, the defendant has the burden to prove entire fairness.[337] Ordinarily, the plaintiff must also prove causation and injury. However, to the student of tort law, burden shifting to the defendant to prove elements of the prima facie cause of action, such as causation and injury, is hardly foreign. Courts sitting in tort law have presumed negligence in the absence of direct evidence and have shifted the burden of showing non-negligence to the defendant;[338] they have shifted the burden of identifying the culpable defendant to a group of defendants;[339] they have shifted the burden of proof on causation to the defendant;[340] and they have even eliminated the traditional causation inquiry from the plaintiff's case altogether.[341] Such is the innovations of common law courts in solving thorny social problems.

In *Cede*, we see the innovation of the common law process at work in the field of corporate law. Shifting the burden of showing causation and injury to the defendant under the entire fairness standard is

333 *See, e.g.*, Martin v. Herzog, 126 N.E. 814, 816 (N.Y. 1920) ("We must be on our guard, however, against confusing the question of negligence with that of the causal connection between the negligence and the injury.").

334 *Compare* Palsgraf v. Long Island R.R. Co., 162 N.E. 99, 99–100 (N.Y. 1928), *with id.* at 102 (Andrews, J., dissenting).

335 *Cede*, 634 A.2d at 351 ("[W]e find the business judgment presumption . . . to have been rebutted for board lack of due care.").

336 *Id.* at 350 ("We . . . conclude that the trial court . . . erred . . . in reformulating the business judgment rule's elements . . . .").

337 *Id.* at 371.

338 *See generally* Byrne v. Boadle, (1863) 159 Eng. Rep. 299 (Exch.) (invoking the doctrine of res ipsa loquitur).

339 *See* Summers v. Tice, 199 P.2d 1, 4 (Cal. 1948) (en banc); Ybarra v. Spangard, 154 P.2d 687, 690 (Cal. 1944).

340 *See* Sindell v. Abbott Labs., 607 P.2d 924, 936–37 (Cal. 1980); Haft v. Lone Palm Hotel, 478 P.2d 465, 470 (Cal. 1970) (en banc).

341 *See* Hymowitz v. Eli Lilly & Co., 539 N.E.2d 1069, 1072–73 (N.Y. 1989).

consistent with tort principles, even for a breach of the duty of care.[342] Unlike most tort accidents, causation and loss in business transactions may be difficult to prove because of the abstract nature of economic injuries, and the task is made more difficult due to the information asymmetry between plaintiff and defendant.[343] Once the difficult task of showing a wrong has been accomplished under the exacting substantive and procedural standards of corporation law, burden shifting on the issue of causation and injury, as well as a more robust judicial inquiry, makes sense in light of the proven wrong, the difficulties of proof on causation and injury, and the pervasive information asymmetry. Thus, *Cede* is a good example of how courts sitting in corporation law develop flexible doctrines requiring a balance between management authority and judicial inquiry.

Ultimately, courts are the arbiters of what is and is not a legal wrong in fiduciary relationships, and the duty of care and the business judgment rule must be construed as a "judicial creature" subject to the evolution in the common law process.[344]

Conclusion

A flawed tort analogy has been a major reason for the confusion over the relationship between the duty of care and the business judgment rule. The laws of torts and corporation converge. The foundational principles governing the duty of care and the business judgment rule rests on a tort foundation. Under a corrected tort analogy, the duty of care is a misnomer to the extent that it suggests liability for economic loss caused by errors in judgment. Corporation law is correct to preclude substantive review of good or bad risk taking and the outcomes there from because the scope of the duty does not extend that far when we consider the nature of a director's affirmative obligation and economic analyses of lost profit. Contractarian expla-

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342 *But see* BAINBRIDGE, *supra* note 1, at 289 (arguing that the entire fairness standard should not apply to a breach of care case); Allen et al., *Realigning the Standard*, *supra* note 4, at 461–62 (same).

343 *See* Seinfeld v. Verizon Commc'ns, Inc., 909 A.2d 117, 120 (Del. 2006) ("[S]tockholders [can] use the 'tools at hand' to obtain the necessary information before filing a derivative action." (quoting Grimes v. Donald, 673 A.2d 1207, 1216 (Del. 1996))); Beam v. Stewart, 845 A.2d 1040, 1056 (Del. 2004) ("In general, derivative plaintiffs are not entitled to discovery in order to demonstrate demand futility."); *see also* DEL. CODE ANN. tit. 8, § 220(b) (1974) (giving stockholders the right to inspect a company's records).

344 "The judicial articulation of fiduciary duty law in Delaware is constantly evolving and has developed over about eight or nine decades. It is the quintessential application of the common law process." Veasey & Di Guglielmo, *supra* note 318, at 1413.

nations and tort principles converge in a coherent view of fiduciary obligations and the court's role in stating and enforcing them. The duty *of* care is really an affirmative duty *to* the care for the corporation inherent in the statutory grant of authority to the board. That duty means that the board must affirmatively make decisions in good faith, do so advisedly, and must not abdicate its function. Not surprisingly, such failures are not covered by the business judgment rule and directors are exposed to liability. Thus, the meaning of negligence derives from the substance given to the director's duty by the participants of the corporate enterprise.

The thesis of this Article also has a larger implication. If the tort analogy is robust, the contractarian view of corporation law is constrained by the tort foundation of corporation law. Whereas the contractarian analysis emphasizes freedom of contract and diminishes the role of courts to custodians of the corporate contract and legislative mandates, a tort framework argues that courts do and should play a robust, albeit reserved, role in regulating important aspects of corporate governance through continued doctrinal development of the idea of a wrong. A tort framework better accommodates the incorporation and recognition of normative value judgments in judicial decisionmaking. The implication of this view extends to the various corners of corporation law, including among other issues, limited liability, fiduciary duty, public rescue, executive compensation, and takeover defenses.