

# Individual or Collective Liability for Corporate Directors?

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

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## I. INTRODUCTION

Efforts to improve corporate governance routinely focus on the board of directors, which enjoys almost unfettered control over the corporation.<sup>1</sup> Given the board's broad authority,<sup>2</sup> policymakers, courts, and legal scholars constantly look for ways to improve board functioning, especially in the wake of scandals at Enron, WorldCom, and other corporations.<sup>3</sup> Making directors independent of management is a popular theme,<sup>4</sup> as are calls for subjecting directors to more robust fiduciary duties. Fiduciary duties are meant to reduce agency costs between shareholders and directors. Currently, however, fiduciary duties are generally a weak impetus for motivating directors to act in the best interests of shareholders, at least to the extent that fiduciary law would seek to impose liability for director wrongdoing. This recognition has led some corporate law scholars to call for stricter fiduciary duties, which could take the form of an explicit duty to act in good faith<sup>5</sup> or a revival of the duty of care, which is now on life support.<sup>6</sup> Other

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1. See DEL. CODE ANN. tit. 8, § 141(a) (2001) ("The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors . . .").

2. For arguments in favor of this broad authority as a normative matter, see generally Stephen M. Bainbridge, *Director Primacy and Shareholder Disempowerment*, 119 HARV. L. REV. 1735 (2006); Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547 (2003) [hereinafter Bainbridge, *Director Primacy: Means and Ends*].

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

4. Director independence is a defining feature of the Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002) (codified in scattered sections of 15 U.S.C. and 18 U.S.C.). Also, the New York Stock Exchange ("NYSE") and the National Association of Securities Dealers Automated Quotient ("NASDAQ") now require that listed companies have a majority of independent directors. *But see generally* Sanjai Bhagat & Bernard Black, *The Uncertain Relationship Between Board Composition and Firm Performance*, 54 BUS. LAW. 921 (1999) (an empirical study suggesting that greater director independence does not improve corporate performance and that too many independent directors may actually hurt corporate performance). On the merits of greater director independence, see also *infra* notes 62–63 and 160.

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

6. See Lisa M. Fairfax, *Spare the Rod, Spoil the Director? Revitalizing Directors' Fiduciary Duty Through Legal Liability*, 42 HOUS. L. REV. 393, 407–08 (2005) (observing with disfavor that "[o]ver the last twenty years, a variety of mechanisms have contributed to a virtual elimination of legal liability for directors who breach their duty of care"); Renee M. Jones, *Law, Norms, and the Breakdown of the Board: Promoting Accountability in Corporate Governance*, 92 IOWA L. REV. 105, 109 (2006) (arguing in favor of due care liability calibrated by an individual director's ability to pay); Cheryl L. Wade, *Corporate Governance Failures and the Managerial Duty of Care*, 76 ST. JOHN'S L. REV. 767, 768 (2002) ("[G]reater emphasis on standards of care for both directors and

corporate law scholars (and, judging by the recent *Disney* case,<sup>7</sup> Delaware courts) take a more pessimistic view of fiduciary duty liability as a potential cure for what ails boards, preferring to leave corporate governance to other devices, including market sanctions.<sup>8</sup>

The fiduciary duty literature is rich and fruitful, and thus it is surprising that one important question within fiduciary law—a question that bears upon many of the others—has been virtually ignored. Directors, of course, do not operate in isolation; they are capable of acting only by majority vote.<sup>9</sup> In practice, they usually act unanimously.<sup>10</sup> Yet each director is an individual, and each will either comply or not comply with the standards set by fiduciary law. For example, one director may have a conflict of interest, while the remaining board members do not. Also, different directors may have exercised different levels of carefulness in reaching their decisions. Given these differences (or potential differences) among directors, what impact does one director's fiduciary duty breach have on the liability of the remaining directors? Or, flipping the question, what impact does the compliance of the remaining directors have on the liability of the one breaching director? More broadly, the unexplored question within fiduciary duty law is this: how are outcomes affected when, although all directors vote

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officers is warranted, especially in the aftermath of the corporate governance failures that scandalized Enron, WorldCom, and other large publicly held companies.”).

7. The *Disney* case, which spent the last several years bouncing between the Delaware Chancery and Supreme Courts, involved notably lax behavior on the part of Disney's board of directors in the hiring and firing of President Michael Ovitz. Ovitz received an approximately \$130 million severance package for fourteen months of work, which prompted a shareholder suit alleging fiduciary duty breaches in connection with the payout. See *In re The Walt Disney Co. Derivative Litig. (Disney V)*, 906 A.2d 27, 35 (Del. 2006). The directors were ultimately exonerated by both the Delaware Chancery Court and the Delaware Supreme Court. See *In re The Walt Disney Co. Derivative Litig. (Disney IV)*, 907 A.2d 693 (Del. Ch. 2005); *Disney V*, 906 A.2d at 27. The *Disney* case is discussed *infra* Section II.A.3.

8. See, e.g., Larry E. Ribstein, *The Mandatory Nature of the ALI Code*, 61 GEO. WASH. L. REV. 984, 1027 (1993) (“A particularly questionable academic position . . . is that fiduciary duties, structures, and remedies must be imposed by law because market forces alone cannot eliminate agency costs.”).

9. DEL. CODE ANN. tit. 8, § 141(b) (2001) (“The vote of the majority of the directors present at a meeting at which a quorum is present shall be the act of the board of directors unless the certificate of incorporation or the bylaws shall require a vote of a greater number.”).

10. Bayless Manning, *The Business Judgment Rule and the Director's Duty of Attention: Time for Reality*, 39 BUS. LAW. 1477, 1483 (1984) (“Actions [of the board] are usually by consensus. If a significant sentiment of disagreement is sensed by the chairman, the matter is usually put over for later action, and sources of compromise and persuasion are pursued in the interim.”); see also James D. Cox & Harry L. Munsinger, *Bias in the Boardroom: Psychological Foundations and Legal Implications of Corporate Cohesion*, LAW & CONTEMP. PROBS., Summer 1985, at 83, 91 (“[A] new board member is expected not only to work within the group's collective views of the corporate interest, but also to cooperate with other board members in reaching decisions by group consensus.”).

the same way,<sup>11</sup> some do so in compliance with their fiduciary duties while others do not? Should director liability be assessed individually or collectively?

An individual focus does not allow a director to hide behind her fellow directors' compliance, but instead deems her singular breach of sufficient gravity to jeopardize the board's functioning and warrant legal sanctions. A collective focus, on the other hand, will serve to insulate any one director's wrongdoing provided the remaining directors complied with their fiduciary duties.<sup>12</sup> Therefore, how courts answer the individual/collective question can have important practical ramifications. Although the choice between treating directors individually or treating them collectively is only one of the variables in fiduciary duty suits, it has the potential to be the difference between a director's liability and her exoneration. As a result, it carries significant financial implications for directors, shareholders, insurers, and attorneys. Moreover, how courts answer the individual/collective question can affect how directors interact with one another and can provide important insights into the judicial view of fiduciary duty liability as a corporate governance mechanism.

This Article favors a duty-specific answer to the individual/collective question on both descriptive and normative grounds. First, it shows that courts generally have focused on the board as a whole in duty of care cases, and on directors as individuals in duty of loyalty cases. Second, this Article argues that courts have been correct in drawing this duty-based distinction because it strikes the proper balance between the board's authority and its

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11. Directors who vote against a particular course of action should be immune from liability. *See Francis v. United Jersey Bank*, 432 A.2d 814, 826 (N.J. 1981) ("Usually a director can absolve himself from liability by informing the other directors of the impropriety and voting for a proper course of action."). The Delaware General Corporation Law allows this:

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

DEL. CODE ANN. tit. 8, § 174(a) (2001).

The absentee director presents a more difficult case. Courts have held directors liable for board decisions made in their absence, although this is sometimes in the banking context where fiduciary duties are heightened. *See FDIC v. Bierman*, 2 F.3d 1424, 1433 (7th Cir. 1993) ("The fact that an absentee director had no knowledge of the transaction and did not participate in it does not absolve him of liability."); *Hoye v. Meek*, 795 F.2d 893, 897 (10th Cir. 1986) (holding a semi-retired bank director liable for breaching his duty of care because he did not take affirmative steps to become informed about the actions of another director). For an example outside of the banking context, see the discussion of absentee-director O'Boyle's liability in *Smith v. Van Gorkom*, *infra* note 30.

12. *See infra* notes 95–99 and accompanying text.

accountability in each case.<sup>13</sup> It contends that loyalty breaches, if committed by even a single director, are likely to impact the board's functioning in a meaningful way, and therefore those breaches warrant greater accountability through an individual director focus. On the other hand, due care breaches committed by only one director are unlikely to jeopardize the board's functioning in the same way, and therefore these breaches call for a more deferential collective focus. Because good faith now appears to be a subset of the duty of loyalty,<sup>14</sup> and because it too involves intentional wrongdoing as presently defined,<sup>15</sup> allegations of bad faith also warrant an individual director focus. This Article does not extend the individual/collective analysis to the so-called enhanced or intermediate scrutiny cases found in the takeover context, which present a more difficult question because it is unclear whether a board that enacts takeover defenses is acting intentionally to serve its own interests by staying in power or acting in the best interests of shareholders by thwarting an inadequate bid.<sup>16</sup>

After contending that courts are properly oscillating between a collective and individual focus to director liability depending on whether the duty of care or the duty of loyalty is at issue, this Article asks what broader lessons we might take away from this. It suggests that this duty-based distinction reveals a further splintering between the duties of care and loyalty, and by only adopting the stricter individual approach in duty of loyalty cases, courts are further de-emphasizing fiduciary duty liability as a corporate governance mechanism. On the other hand, that courts have only *implicitly* adopted the more lax collective approach in duty of care cases suggests that the duty of care is still important as an aspirational "standard of conduct," if not a "standard of liability."<sup>17</sup>

This Article proceeds as follows. Part II discusses the existing law on the collective versus individual treatment of directors in fiduciary duty suits. This law is comprised of cases that explicitly address the question, cases that implicitly address it, and statutes from Delaware and the Model Business Corporation Act ("MBCA"). Existing law reveals a preference for an individual director focus in duty of loyalty cases and a preference for a collective focus in duty of care cases. Part III first sets forth the normative criteria that should inform the choice between the two assessment approaches on corporate governance policy grounds and then applies those criteria to different types of fiduciary duty claims that a plaintiff may bring. It concludes that courts are creating good corporate governance policy

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13. See *infra* Part III.A.1.

14. After the Delaware Supreme Court's recent decision in *Stone v. Ritter*, 911 A.2d 362 (Del. 2006), it appears settled that the duty to act in good faith is a subset of the duty of loyalty rather than an independent fiduciary duty. See *infra* Part III.B.1.b.

15. See *infra* Part III.B.1.b.

16. See *infra* note 191 and accompanying text.

17. See *infra* notes 181–89.

through their duty-based distinction. Part IV draws broader implications about fiduciary duties from the courts' resolution of the individual/collective question. Part V concludes.

## II. THE INDIVIDUAL/COLLECTIVE QUESTION: EXISTING LAW

Existing law on the individual/collective question is difficult to decipher. Forming any sort of a coherent picture about how the law views this question requires piecing together case law that explicitly addresses the question, case law that implicitly addresses it, and relevant statutory provisions from Delaware and the MBCA. Engaging in this exercise reveals a focus that shifts between an individual or collective approach depending on the type of fiduciary breach being litigated. Duty of loyalty claims tend to be analyzed using an individual approach, while duty of care claims tend to be analyzed using a collective approach.<sup>18</sup>

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

### A. CASES EXPLICITLY ADDRESSING THE INDIVIDUAL/COLLECTIVE QUESTION

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

The first of the three Delaware cases to explicitly address the collective versus individual treatment of directors in fiduciary duty suits was the famous case of *Smith v. Van Gorkom*.<sup>19</sup> In that case, decided in 1985, the Delaware Supreme Court took the unprecedented step of holding all ten directors of Trans Union Corporation jointly and severally liable for \$23.5 million for breaching their duty of care in approving the sale of the corporation.<sup>20</sup> Trans Union's Chairman and CEO, Jerome Van Gorkom, orchestrated the sale with the help of another inside director, Bruce

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18. Roberta Romano has suggested this answer to the individual/collective question when discussing board stability. Roberta Romano, *Corporate Governance in the Aftermath of the Insurance Crisis*, 39 EMORY L.J. 1155, 1178 n.39 (1990) ("A duty of care violation is likely to involve the entire board, whereas a duty of loyalty violation tends to be limited to directors (typically insiders) who have personally benefited from a transaction.").

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

20. The directors reportedly paid very little of this amount. Their Directors' & Officers' ("D&O") insurance paid \$10 million—the policy limit—and the acquiror, Jay Pritzker, paid nearly all of the \$13.5 million balance. Bayless Manning, *Reflections and Practical Tips on Life in the Boardroom After Van Gorkom*, 41 BUS. LAW. 1, 1 n.\* (1985).

Chelberg.<sup>21</sup> The remainder of the board was not informed of the proposal until the day before the buyer's deadline to accept it.<sup>22</sup> The board approved the sale based on a twenty-minute presentation by Van Gorkom, supported by Chelberg, as well as the advice of Trans Union's legal counsel and the directors' "knowledge of the market history of the Company's stock."<sup>23</sup>

When Trans Union shareholders brought a class action suit against the directors, the directors elected to present a unified defense.<sup>24</sup> The court held that "since all of the defendant directors, outside as well as inside, take a unified position, we are required to treat all of the directors as one as to whether they are entitled to the protection of the business judgment rule."<sup>25</sup> Pursuant to this collective approach, the court did not distinguish among Van Gorkom's orchestration of the transaction without the board's knowledge, Chelberg's complicity, and the board's failure to become adequately informed or to sufficiently deliberate once it learned of the proposal. Instead, because the directors presented a uniform defense for their actions, the court held that they should be treated as a unit for assessing liability.

In this particular case, the collective approach was adopted at the directors' request. Justice Andrew Moore, at least, appeared skeptical that a collective focus was appropriate. During the appeal, the Delaware Supreme Court requested a special hearing to determine whether there were "factual or legal reasons" to treat the directors differently.<sup>26</sup> In the hearing, Justice Moore and the directors' common counsel engaged in the following colloquy:

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

COUNSEL: No, sir.

JUSTICE MOORE: None whatsoever?

COUNSEL: I think not.<sup>27</sup>

According to Charles O'Kelley and Robert Thompson, the court was "trying to drive a wedge between directors who were negligent or disloyal and those who were not."<sup>28</sup> The directors, however, chose the collective

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21. *Van Gorkom*, 488 A.2d at 865–68.

22. *Id.* at 867.

23. *Id.* at 869.

24. *Id.* at 899 (ruling on defendants' Motions for Reargument).

25. *Id.* at 889.

26. *Van Gorkom*, 488 A.2d at 899.

27. *Id.*

28. CHARLES R.T. O'KELLEY & ROBERT B. THOMPSON, CORPORATIONS AND OTHER BUSINESS ASSOCIATIONS: TEACHER'S MANUAL 111 (4th ed. 2003); *see also* Jonathan R. Macey, Smith v. Van Gorkom: *Insights About C.E.O.s, Corporate Law Rules, and the Jurisdictional Competition for Corporate*

strategy in the hopes that the court would be unwilling to find the outside directors liable, thereby also shielding the more culpable insiders. The *Van Gorkom* court did honor the directors' request for collective treatment, but instead of exonerating the directors, it "exploded a bomb"<sup>29</sup> by splitting 3–2 in favor of liability for the whole board, which included a director who was ill and had not been present at the meeting where the sale was approved.<sup>30</sup> Justice Moore, one of the three judges voting in favor of liability, later stated that "the strategic maneuver to cast down the gauntlet before the Delaware Supreme Court hardly appears to have been among the wisest decisions in the annals of corporate America."<sup>31</sup>

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

After *Van Gorkom*, the Delaware courts did not explicitly revisit the individual/collective question until 2004 in the case of *In re Emerging Communications, Inc. Shareholders Litigation*.<sup>32</sup> This class action suit alleged that the directors of Emerging Communications, Inc. breached their fiduciary duties in approving a "going private" acquisition of the company by its Chairman and CEO, Jeffrey Prosser.<sup>33</sup> The transaction was originally

*Charters*, 96 NW. U. L. REV. 607, 609–19 (2002) (arguing that in *Van Gorkom* the whole board was punished for what was predominantly Jerome Van Gorkom's misconduct); cf. Elliott J. Weiss, *What Lawyers Do When the Emperor Has No Clothes: Evaluating CTS Corp. v. Dynamics Corp. of America and Its Progeny—Part I*, 78 GEO. L.J. 1655, 1658 n.18 (1990) ("In my view, the *Van Gorkom* court was concerned primarily with the manner in which Van Gorkom . . . presented the proposed transaction to the board, and with the outside directors' refusal to dissociate themselves from Van Gorkom when they learned that he had provided them with incomplete information.").

29. Manning, *supra* note 20, at 1.

30. Upon release of the court's judgment of liability, this outside director, Thomas O'Boyle, was granted leave for a change of counsel. In his motion for reargument, O'Boyle claimed "standing to take a position different from that of his fellow directors and that legal grounds exist[ed] for finding him not liable for the acts or omissions of his fellow directors." *Van Gorkom*, 488 A.2d at 898. The court unanimously ruled that this argument had been waived, noting that during trial "a special opportunity was afforded the individual defendants, including O'Boyle, to present any factual or legal reasons why each or any of them should be individually treated." *Id.* at 898–99.

31. Andrew G.T. Moore II, *The 1980s—Did We Save the Stockholders While the Corporation Burned?*, 70 WASH. U. L.Q. 277, 282 (1992). Justice Moore comments on the holding:

This [collective] position was taken even though it was obvious that certain directors were more culpable than others, and in the face of the Court's invitation that they take separate positions with a clear hint of exoneration for all but the most culpable insiders . . . . In a way, they were "daring" us to find them all liable to save certain insiders.

*Id.*

32. *In re Emerging Commc'ns, Inc. S'holders Litig.*, No. Civ.A 16415, 2004 WL 1305745, at \*9 (Del. Ch. May 3, 2004).

33. The privatization occurred in two steps. First, Innovative Communications Corporation, L.L.C., which was effectively wholly owned by Prosser and was already the majority stockholder of Emerging Communications, acquired twenty-nine percent of Emerging

proposed to be a merger of another corporation owned by Prosser into Emerging Communications.<sup>34</sup> Prosser, however, “flipped” the transaction to a privatization in which his other corporation would acquire Emerging Communications due to his belief that the market had undervalued Emerging Communications, making it available for purchase at a discounted price.<sup>35</sup>

The Emerging Communications board was comprised of seven directors, including inside director Prosser, inside director and company counsel John Raynor, and outside director and financial expert Salvatore Muoio. Justice Jacobs of the Delaware Supreme Court, sitting by designation on the Chancery Court, found these three directors, but no others, jointly and severally liable for breaching their fiduciary duties of loyalty “and/or” good faith in approving the privatization at \$10.25 per share in light of the judicially determined fair value of \$38.05 per share.<sup>36</sup>

In his opinion, without citing *Van Gorkom*, Justice Jacobs held that “[t]he liability of the directors must be determined on an individual basis because the nature of their breach of duty (if any), and whether they are exculpated from liability for that breach, can vary for each director.”<sup>37</sup> Applying this individual approach, Justice Jacobs imposed liability on Prosser for violating his duty of loyalty by self-dealing,<sup>38</sup> Raynor for breaching his duty of loyalty “and/or” good faith by assisting Prosser in the privatization and by “consciously disregarding his duty to the minority stockholders,”<sup>39</sup> and Muoio for breaching his duty of loyalty “and/or” good faith because he was not independent of Prosser and “voted to approve the transaction even though he knew, or at the very least had strong reasons to believe, that the \$10.25 per share merger price was unfair,” given his financial expertise.<sup>40</sup> The other four directors, although “not independent of Prosser,”<sup>41</sup> were exonerated because their conduct did not rise to the level of disloyalty or bad faith.<sup>42</sup>

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Communications’ outstanding shares in a first-step tender offer. Second, two months later, Innovative acquired the balance of the outstanding shares in a second-step cash-out merger of Emerging Communications into an Innovative subsidiary. *Id.* at \*1. Afterward, Prosser effectively owned Innovative and Emerging Communications. *Id.*

34. *Id.* at \*5.

35. *Id.*

36. *Id.* at \*11, \*38–39.

37. *In re Emerging Commc’ns*, 2004 WL 1305745, at \*38.

38. *See id.* at \*39 (finding him liable for breach of the duty of loyalty as a director). Prosser also breached his duty of loyalty as a majority stockholder of Emerging Communications “by eliminating [the company’s] minority stockholders for an unfair price in an unfair transaction that afforded the minority no procedural protections.” *Id.* at \*38.

39. *Id.* at \*39 & n.184.

40. *Id.* at \*39–40.

41. *Id.* at \*41.

42. The court stated:

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

In 2005, Chancellor Chandler issued his opinion on the merits of *In re The Walt Disney Co. Derivative Litigation (Disney IV)*.<sup>43</sup> Disney shareholders brought a derivative suit against the corporation's directors in connection with the hiring of Michael Ovitz as Disney's president and his subsequent termination, which resulted in a severance payout to Ovitz of approximately \$130 million for fourteen months' work.<sup>44</sup> The Disney board consisted of seventeen directors, including Chairman and CEO Michael Eisner and compensation committee members Irwin Russell, Raymond Watson, Sidney Poitier, and Ignacio "Nacho" Lozano. Eisner had facilitated Ovitz's hiring, and the compensation committee assumed primary responsibility for the Ovitz employment agreement.

In a lengthy opinion that criticized the directors' conduct in many respects,<sup>45</sup> Chancellor Chandler nevertheless found no fiduciary duty breaches in connection with the Ovitz employment agreement.<sup>46</sup> (In this case, the duties of care and good faith had been implicated.<sup>47</sup>) Before

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

*In re Emerging Commc'ns*, 2004 WL 1305745, at \*41.

43. *In re The Walt Disney Co. Derivative Litig. (Disney IV)*, 907 A.2d 693 (Del. Ch. 2005).

44. *See In re The Walt Disney Co. Derivative Litig. (Disney V)*, 906 A.2d 27, 35 (Del. 2006); *see also* Sean J. Griffith, *Good Faith Business Judgment: A Theory of Rhetoric in Corporate Law Jurisprudence*, 55 DUKE L.J. 1, 17 & n.48 (2005) ("Ovitz was paid approximately \$140 million in stock, cash, and options" but that this "measure is approximate due to the problem of valuing the equity and the options. \$140 million is the plaintiff's measurement of the total cost and may be high.").

45. The specific critiques are numerous, but the gist was that Eisner acted as an imperial CEO who negotiated with Ovitz in secret and that the compensation committee (and, to a lesser extent, the full board) was comprised of Eisner's cronies who simply acceded to his wishes. The court stated:

By virtue of his Machiavellian (and imperial) nature as CEO, and his control over Ovitz's hiring in particular, Eisner to a large extent is responsible for the failings in process that infected and handicapped the board's decisionmaking abilities. Eisner stacked his (and I intentionally write "his" as opposed to "the Company's") board of directors with friends and other acquaintances who, though not necessarily beholden to him in a legal sense, were certainly more willing to accede to his wishes and support him unconditionally than truly independent directors.

*Disney IV*, 907 A.2d at 760–61 (citation omitted).

46. *See id.* at 779 (entering judgment in favor of the defendants on all claims).

47. The traditional duty of loyalty claims had been dropped fairly early in the suit. *See* Griffith, *supra* note 44, at 18–19 (noting that the duty of loyalty claim had been removed from the plaintiffs' complaint before the defendants filed their motion to dismiss).

analyzing the merits of the fiduciary duty claims, Chancellor Chandler took note of the conflicting answers to the individual/collective question set forth in *Van Gorkom* and *Emerging Communications*:

In *Van Gorkom*, the Delaware Supreme Court analyzed the Trans Union board of directors as a whole in determining whether the protections of the business judgment rule applied. More recent cases understand that liability determinations must be on a director-by-director basis. In *Emerging Communications*, Justice Jacobs wrote (while sitting as a Vice Chancellor) that the “liability of the directors must be determined on an individual basis because the nature of their breach of duty (if any), and whether they are exculpated from liability for that breach, can vary for each director.” *There is a not insignificant degree of tension between these two positions*, notwithstanding the procedural differences between the two cases.<sup>48</sup>

After noting the tension between the prior cases, Chancellor Chandler analyzed the conduct of the primary actors (Eisner and each of the compensation committee members) individually.<sup>49</sup> He determined that although their actions did not meet the ideal in corporate practices, neither did they fall below well-established fiduciary duty standards.<sup>50</sup> The actions of the remainder of the board were analyzed only briefly and collectively.<sup>51</sup> The full board was also exonerated.<sup>52</sup> When the Delaware Supreme Court affirmed the Chancellor’s decision in June 2006, it did not reach the substance of the individual/collective question, but instead found that the plaintiffs were procedurally barred from alleging the Chancellor’s use of the individual approach for the primary actors as error.<sup>53</sup> The court added that the plaintiffs had not demonstrated prejudice from this approach.<sup>54</sup>

48. *Disney IV*, 907 A.2d at 748 (citations omitted) (emphasis added).

49. *Id.* at 760–72.

50. *Id.* at 697 (“This Court strongly encourages directors and officers to employ best practices, as those practices are understood at the time a corporate decision is taken. But Delaware law does not—indeed, the common law cannot—hold fiduciaries liable for a failure to comply with the aspirational ideal of best practices . . .”).

51. The Chancellor’s opinion devotes eleven pages to scrutinizing the role of Eisner and the compensation committee members in approving Ovitiz’s employment agreement, *id.* at 760–71, but only two pages to all of the other directors at the time (the “old board”) combined. *Id.* at 771–72. This is because the old board’s sole action was to approve Ovitiz as president—the terms of his employment were delegated to the compensation committee. Plaintiffs raised the issue of this delegation of authority in their appeal to the Delaware Supreme Court, which the court rejected. *See In re The Walt Disney Co. Derivative Litig. (Disney V)*, 906 A.2d 27, 54 (Del. 2006) (“The Chancellor’s ruling—that executive compensation was to be fixed by the compensation committee—is legally correct.”).

52. *Disney IV*, 907 A.2d at 771–72.

53. As the court noted:

*B. CASES IMPLICITLY ADDRESSING THE INDIVIDUAL/COLLECTIVE QUESTION*

Although *Van Gorkom*, *Emerging Communications*, and *Disney* all explicitly addressed the individual/collective question, standing alone they do not tell us very much. *Emerging Communications* supports an individual focus for duty of loyalty claims, but it is only one case. Justice Jacobs gave little reasoning for his individual focus. However, other case law is clear that consequences flow from even one director's disloyalty. For instance, corporate opportunity cases (a subset of the duty of loyalty cases) routinely center on allegations that a single director has usurped a corporate opportunity.<sup>55</sup> The consequences of disloyalty begin with greater judicial scrutiny of the challenged transaction, and potentially end with the imposition of liability on the disloyal director.<sup>56</sup> The relevant Delaware statutory provision, discussed below, is equally clear that an individual focus is required in duty of loyalty cases.<sup>57</sup> Although the good-faith jurisprudence to this point has been quite confusing and in flux, *Emerging Communications* could be read to support an individual focus when good faith is implicated.<sup>58</sup>

*Van Gorkom* and *Disney* are less clear in their resolution of the individual/collective question in duty of care cases. In *Disney*, Chancellor Chandler cited *Van Gorkom* as adopting the collective focus, yet the *Van Gorkom* court chose the collective approach due to the directors' request, rather than through any substantive reasoning. Similarly, it is difficult to know what to make of *Disney*, where allegations of carelessness were interwoven with allegations of bad faith to propel plaintiffs past an early motion to dismiss.<sup>59</sup> The Delaware Supreme Court did not address the

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To begin with, the argument is precluded by Rule 8 of this Court, which provides that arguments not fairly presented to the trial court will not be considered by this Court. The appellants' "individual vs. collective" argument goes beyond being not fairly presented. It borders on being unfairly presented, since the appellants are taking the trial court to task for adopting the very analytical approach that they themselves used in presenting their position.

*Disney V*, 906 A.2d at 55 (citation omitted).

54. See *id.* ("The argument also fails because nowhere do appellants identify how this supposed error caused them any prejudice.")

55. See, e.g., *Broz v. Cellular Info. Sys., Inc.*, 673 A.2d 148, 150 (Del. 1996); *Guth v. Loft, Inc.*, 5 A.2d 503 (Del. 1939).

56. *Broz*, 673 A.2d at 154–58. Note, however, that although the Chancery Court found that Mr. Broz breached his duty of loyalty, the Delaware Supreme Court reversed. *Id.* at 159.

57. See *infra* Part II.C.1 (discussing Delaware General Corporation Law § 144).

58. See *supra* Part II.A.2 (discussing Justice Jacobs's individual director focus when analyzing breaches of the duties of loyalty "and/or" good faith).

59. Duty of care claims, standing alone, are subject to dismissal if the corporation has adopted a Section 102(b)(7) provision. See *infra* notes 141–44 and accompanying text (discussing Delaware General Corporation Law § 102(b)(7)); see also Norman E. Veasey with 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, 1440–41 (2005) ("[T]he *Disney* litigation—as the Supreme Court saw it in *Brehm v. Eisner* in 2000, based on the original

substance of the individual/collective question because it was procedurally barred on appeal<sup>60</sup>—Chancellor Chandler took note of the question and adopted somewhat of a hybrid approach, analyzing Eisner and the compensation committee individually and the remainder of the board collectively. Cases that have *implicitly* resolved this issue, however, support *Van Gorkom's* collective focus in duty of care cases.

Courts generally do not draw distinctions among directors based on their inside/outside director status or expert/nonexpert qualifications when assessing compliance with the duty of care;<sup>61</sup> this points toward a collective focus. First, even though “inside” and “outside” directors serve different functions,<sup>62</sup> with inside directors managing corporate affairs and outside directors playing more of a monitoring role,<sup>63</sup> courts generally do not hold inside directors to a higher standard of care. For example, in *Norlin Corp. v. Rooney, Pace Inc.*, the Second Circuit stated that “[w]e are not persuaded that a different test applies to ‘independent’ as opposed to ‘inside’ directors

and defective set of pleadings—seemed to be primarily a due care case. . . . On remand, the case, as repleaded, morphed into a ‘good faith’ case.”).

60. See *supra* note 53 and accompanying text.

61. Courts do distinguish between inside and outside/independent directors for other purposes, however. See *infra* note 99 (discussing instances where approval by outside/independent directors results in less judicial scrutiny of the decision).

62. This Article draws a basic distinction between inside directors, who are also officers or management of the corporation, and outside directors, who are not. See CHARLES R.T. O’KELLEY & ROBERT B. THOMPSON, CORPORATIONS AND OTHER BUSINESS ASSOCIATIONS: CASES AND MATERIALS 136 (4th ed. 2003) (noting that inside directors are “generally the chief executive officer and her principal subordinate officers,” while outside directors “usually are employed full time as chief executives or financial officers of other corporations, or are lawyers, accountants, or investment bankers”). Outside directors may or may not qualify as “independent” directors, depending on the standard used. See Hillary A. Sale, *Independent Directors As Securities Monitors*, 61 BUS. LAW. 1375, 1376 n.4 (2006) (noting that to be independent under NYSE rules, “directors must not have any significant familial or financial ties with the company,” while to be independent under Delaware law, “a director must not be beholden to her fellow board members and be able to formulate her own decisions on issues free of improper influence”). For criticism of the more formalistic NYSE definition of independence, see generally Stephen M. Bainbridge, *A Critique of the NYSE’s Director Independence Listing Standards*, 30 SEC. REG. L.J. 370 (2002). For an alternative approach to independence, see generally Note, *Beyond “Independent” Directors: A Functional Approach to Board Independence*, 119 HARV. L. REV. 1553 (2006).

63. As noted by Ronald J. Gilson and Reinier Kraakman:

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

Ronald J. Gilson & Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STAN. L. REV. 863, 873 (1991). On monitoring versus managing boards, see MELVIN ARON EISENBERG, *THE STRUCTURE OF THE CORPORATION: A LEGAL ANALYSIS* 162–69 (1976).

under the business judgment rule.”<sup>64</sup> There are exceptions in the case law, however,<sup>65</sup> and outside directors are entitled to greater reliance on reports made by corporate officers, accountants, or appraisers in fulfilling their duty of care than are inside directors.<sup>66</sup>

Courts also tend to hold expert and nonexpert directors to the same standard of care. For example, in the 2006 case of *Canadian Commercial Workers Industry Pension Plan v. Alden*, the Delaware Chancery Court held that “Plaintiff’s argument that Defendants should be held to a higher standard of care because they are [an accountant and a lawyer] is unavailing.”<sup>67</sup> Norman Veasey, former chief justice of the Delaware Supreme Court, recently opined that “[i]t would be a perversity of corporate governance goals, in my view, for the Delaware courts to announce a general rule that a director with special expertise is more exposed to liability than other directors solely because of her status as an expert.”<sup>68</sup> Justice Jacobs’s more stringent treatment of financial expert Muoio in *Emerging Communications* appears to be an exception to this general rule,<sup>69</sup> although that opinion can be read to call into question Muoio’s good faith due to his expert status rather than

64. *Norlin Corp. v. Rooney, Pace Inc.*, 744 F.2d 255, 267 n.12 (2d Cir. 1984); see also Donald E. Pease, *Outside Directors: Their Importance to the Corporation and Protection from Liability*, 12 DEL. J. CORP. L. 25, 49 (1987). Discussing the well-known Delaware case of *Aronson v. Lewis*, 473 A.2d 805 (Del. 1984), Pease states:

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

*Id.* (citations omitted).

65. See *Rowen v. Le Mars Mut. Ins. Co. of Iowa*, 282 N.W.2d 639, 652 (Iowa 1979) (subjecting outside directors to lesser fiduciary duty standards because “an outside director does not have the same duty or responsibility that falls upon those who are in active charge and who dictate day-to-day policy”).

66. Section 141(e) of the Delaware General Corporation Law provides:

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

DEL. CODE ANN. tit. 8, § 141(e) (2001).

67. *Canadian Commercial Workers Indus. Pension Plan v. Alden*, No. Civ.A. 1184-N, 2006 WL 456786, at \*7 n.54 (Del. Ch. Feb. 22, 2006).

68. Veasey with Di Guglielmo, *supra* note 59, at 1446 (emphasis omitted).

69. See *supra* note 40 and accompanying text (discussing the court’s imposition of liability against Muoio, in part because of his financial expertise).

alter his standard of care.<sup>70</sup> (If the latter reading is correct, it also supports an individual focus in good faith cases.) Whether there should be an expert/nonexpert distinction has been the topic of recent discussion, particularly as it relates to audit committees.<sup>71</sup>

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

### C. RELEVANT STATUTORY PROVISIONS

#### 1. Delaware General Corporation Law Section 144

Finally, two important statutory provisions on fiduciary duties add to our body of existing law addressing the individual/collective question. The first is Delaware General Corporation Law Section 144, which speaks to the duty of loyalty and holds that certain transactions are not void solely because of “1 or more” directors’ self-dealing.<sup>72</sup> Three mechanisms can save a self-dealing transaction from automatic voidability: (1) disclosure of the conflict followed by the approval of disinterested directors, (2) disclosure of the conflict followed by the approval of shareholders, or (3) a judicial

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70. This is how Chief Justice Veasey appears to read *Emerging Communications*. In discussing Muoio’s liability, he states:

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

Veasey with Di Guglielmo, *supra* note 59, at 1446 (emphasis omitted).

71. The SEC has come out against a heightened standard of liability for financial experts on audit committees. See Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act, Exchange Act Release No. 47,235, [2002–2003 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,818, at 86,894 (Jan. 23, 2003) (“Our new rule provides that whether a person is, or is not, an audit committee financial expert does not alter his or her duties, obligations or liabilities . . . under federal or state law.”). For conflicting views on whether audit committee members should be held to a higher standard of care, compare Jill E. Fisch & Caroline M. Gentile, *The Qualified Legal Compliance Committee: Using the Attorney Conduct Rules to Restructure the Board of Directors*, 53 DUKE L.J. 517, 572 (2003) (“If, as the Commission’s safe harbor suggests, audit committee members do not face increased liability exposure, is it realistic to expect them to play an active role?”), with Kevin Iurato, Comment, *Warning! A Position on the Audit Committee Could Mean Greater Exposure to Liability: The Problems with Applying a Heightened Standard of Care to the Corporate Audit Committee*, 30 STETSON L. REV. 977 (2001) (arguing against a higher standard of care for audit committee members).

72. DEL. CODE ANN. tit. 8, § 144(a) (2001).

determination that the transaction was fair to the corporation.<sup>73</sup> If the transaction cannot be saved through these mechanisms, the self-dealing director owes damages in an amount equal to the “unfairness” of the transaction, a measure usually based on rescission or restitution.<sup>74</sup>

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

## 2. Model Business Corporation Act Section 8.30

Although this Article focuses on Delaware law, the MBCA has been enacted in some form by a majority of states and therefore constitutes an important source of corporate law.<sup>75</sup> After its 1998 revision, the MBCA was clear in its preference for a collective focus on the directors in duty of care cases.<sup>76</sup> MBCA Section 8.30 speaks to the duty of care as a standard of conduct.<sup>77</sup> The official comment to that Section reads: “While certain aspects [of a director’s performance] will involve individual conduct (*e.g.*, preparation for meetings), these functions are generally performed by the

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73. *See id.*; ROBERT CLARK, CORPORATE LAW, 166–71 (1986) (discussing these mechanisms but noting that disclosure plus either disinterested-director approval or shareholder approval does not mean that a court cannot also inquire into entire fairness). In the past, interested-director transactions were automatically voidable by the corporation regardless of whether they had been disclosed, approved, or were fair to the corporation. Harold Marsh, Jr., *Are Directors Trustees? Conflict of Interest and Corporate Morality*, 22 BUS. LAW. 35, 40 (1966).

74. CLARK, *supra* note 73, at 175 (“For example, when an officer sells property at an unfair, inflated price to his corporation, he becomes liable for the difference between the actual price and the fair value of the property.”); Melvin A. Eisenberg, *Corporate Law and Social Norms*, 99 COLUM. L. REV. 1253, 1276 (1999) (“Generally speaking, the legal sanctions for violating the duty of loyalty are inefficiently low. The primary legal sanctions are rescission and restitution.”); *see also* Weinberger v. UOP, Inc., 457 A.2d 701, 714 (Del. 1983) (“[A]ny form of equitable and monetary relief . . . may be [an] appropriate [remedy for a breach of loyalty], including rescissory damages.”).

75. *See* Veasey with Di Guglielmo, *supra* note 59, at 1417 (“Although Delaware is not a Model Act state, it is sometimes helpful to learn from the articulation of the corporate law in the MBCA. The MBCA is followed in varying forms by a majority of the states . . .”).

76. For a discussion of the 1998 revisions, see R. Franklin Balotti & Joseph Hinsey IV, *Director Care, Conduct, and Liability: The Model Business Corporation Act Solution*, 56 BUS. LAW. 35, 47–56 (2000).

77. The MBCA provides:

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

board through collegial action.”<sup>78</sup> Gordon Smith remarks that in writing the MBCA, the Committee on Corporate Laws “took further pains to subordinate the concept of care, placing it in a separate provision whose wording was intended to suggest that care primarily is a concern of the board as a separate institution, not the individual director.”<sup>79</sup> In their corporations casebook, Jeffrey Bauman, Elliott Weiss, and Alan Palmiter also note the MBCA’s sharp focus on the whole board:

A significant change in the amended MBCA § 8.30 . . . is the emphasis on the board as a collective decision-making body . . . . The Official Comment to MBCA § 8.30 . . . emphasizes that in evaluating board actions, it will be the conduct of the entire board rather than a particular director that will be most important.<sup>80</sup>

In sum, while *Van Gorkom* and *Disney* do not say much about how courts view the individual/collective question in duty of care cases, the case law that implicitly addresses the question suggests a preference for a collective focus. In addition, although there is no statutory provision similar to MBCA Section 8.30 in Delaware,<sup>81</sup> the MBCA provision further reveals a preference for a collective focus in duty of care cases.

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

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

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MODEL BUS. CORP. ACT § 8.30(b) (2002). The standard of liability is found in Section 8.31. *Id.* § 8.31. For a discussion of the difference between standards of conduct and standards of liability, see *infra* notes 181–89 and accompanying text.

78. MODEL BUS. CORP. ACT § 8.30 cmt. 2.

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

80. JEFFREY D. BAUMAN ET AL., CORPORATIONS LAW AND POLICY: MATERIAL AND PROBLEMS 673 (5th ed. 2003).

81. See Smith, *supra* note 79, at 1227 (“It is worth remembering that Delaware does not have a statutory provision prescribing the duty of care.”).

## A. NORMATIVE CRITERIA FOR PROMOTING A WELL-FUNCTIONING BOARD

## 1. Board's Authority/Accountability Balance

Drawing on the work of Nobel laureate economist Kenneth Arrow,<sup>82</sup> Stephen Bainbridge has stated that the balance between a board's authority and its accountability is what "all of corporate law" is intended to achieve.<sup>83</sup> On the one hand, the board has almost complete authority over corporate affairs pursuant to the laws of Delaware<sup>84</sup> and every other state. In theory, shareholders retain some control rights—most notably the rights to elect directors, amend corporate bylaws, and approve certain major transactions—but even these rights are severely limited in practice.<sup>85</sup> The board's wide authority is acknowledged to be "essential for organizational efficiency" given the separation of ownership and control in public corporations.<sup>86</sup> On the other hand, the board must exercise its authority responsibly, as directors who serve their own interests rather than the interests of shareholders do not increase shareholder wealth. Fiduciary duties are one way of holding directors accountable to shareholders, thereby reducing agency costs.<sup>87</sup> Accountability, whether imposed through fiduciary duty law or some other means, serves as the competing principle to

82. KENNETH J. ARROW, *THE LIMITS OF ORGANIZATION* (1974).

83. Stephen M. Bainbridge, *The Business Judgment Rule as Abstention Doctrine*, 57 VAND. L. REV. 83, 84 (2004). Bainbridge states:

My analysis is grounded on the core proposition that the business judgment rule, like all of corporate law, is designed to effect a compromise—on a case-by-case basis—between two competing values: authority and accountability. These values refer, respectively, to the need to preserve the board of directors' decision-making discretion and the need to hold the board accountable for its decisions.

*Id.* (citation omitted). For an earlier discussion of Arrow's work, see D. Gordon Smith, *Corporate Governance and Managerial Incompetence: Lessons from Kmart*, 74 N.C. L. REV. 1037, 1117–19 (1996).

84. See DEL. CODE ANN. tit. 8, § 141 (2001 & Supps. 2006, 2007).

85. For instance, although shareholders have the right to elect directors, they must choose from management's nominees or instigate a proxy fight. Similarly, although shareholders have the right to approve certain major transactions, such as the sale of the corporation, any such action must first be initiated by the board. See Bainbridge, *Director Primacy: Means and Ends*, *supra* note 2, at 568–73 (arguing that "shareholders lack either direct or indirect mechanisms of control" over a corporation). Given this reality, some corporate law scholars argue in favor of increased power for shareholders. See generally Lucian Ayre Bebchuck, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833 (2005); Robert B. Thompson & D. Gordon Smith, *Toward a New Theory of the Shareholder Role: "Sacred Space" in Corporate Takeovers*, 80 TEX. L. REV. 261 (2001). See also LUCIAN BEBCHUK & JESSE FRIED, *PAY WITHOUT PERFORMANCE* 201–16 (2004).

86. Bainbridge, *supra* note 83, at 107.

87. Although directors are not technically agents and shareholders are not technically principals, the agency theory of the firm has "dominated corporate legal scholarship for at least two decades." Thompson & Smith, *supra* note 85, at 268. For the argument that the corporate law literature has overemphasized the importance of agency costs, see generally Douglas G. Baird & Robert K. Rasmussen, *The Prime Directive*, 75 U. CIN. L. REV. 921 (2007).

authority, and “one cannot have more of one without also having less of the other.”<sup>88</sup> The pertinent question, then, is where do we draw the line between authority and accountability to achieve optimal balance?<sup>89</sup>

In fiduciary duty litigation, the answer may seem simple: hold directors accountable only if they breach their fiduciary duties; otherwise, respect their authority. But the matter is more complicated when the individual/collective question presents itself, i.e., when some directors breach and others do not. Employing an individual focus and holding only the breachers liable does not produce optimal results in all cases. Instead, the choice between an individual or collective focus should be informed by the adequacy of the board’s decisionmaking *process*.<sup>90</sup> The goal, after all, is to promote a well-functioning board that will make wealth-enhancing decisions for shareholders. If a single director’s breach jeopardizes that goal, is it not appropriate to account for that? Similarly, if a single director’s breach does not jeopardize that goal, is it not appropriate to take that into consideration as well?

Accordingly, the authority/accountability line should be drawn between board processes that are likely to be adequate—i.e., where we have reasonable confidence that a fiduciary duty breach did not effect the board’s outcome—and those that are not. If the board’s process is likely to be adequate, we should respect the board’s authority through judicial restraint. But if the board’s process is likely to be inadequate, we should favor director accountability through judicial intervention. It is crucial to draw the line in the proper place. Favoring accountability too often would diminish the efficiency benefits of centralized decisionmaking. Too much intrusion into the board’s process and too high an incidence of director liability can chill director risk-taking and dissuade outside directors from serving on boards.<sup>91</sup>

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88. Bainbridge, *supra* note 83, at 103.

89. This question was the subject of an online debate between Gordon Smith and Stephen Bainbridge in September 2006, although that debate concerned increased shareholder participation in corporate governance rather than fiduciary duty litigation. See PointofLaw.com, <http://www.pointoflaw.com/feature/> (last visited Feb. 2, 2008) (search “Smith Bainbridge”; then find postings from September 2006).

90. Corporate law tends to focus on the board’s decisionmaking process rather than the substantive decision that results from that process. Consider corporate law’s most ubiquitous tenet: the business judgment rule. Under the business judgment rule, if a board deliberates in an informed manner and acts in the best interests of the corporation, then a negative substantive outcome will not result in director liability. See *In re Caremark Int’l Inc. Derivative Litig.*, 698 A.2d 959, 967–68 (Del. Ch. 1996) (“The business judgment rule is process oriented”); Melvin Aron Eisenberg, *The Director’s Duty of Care in Negotiated Dispositions*, 51 U. MIAMI L. REV. 579, 590 (1997) (“The sharp differentiation between the standards of review of the quality of board decisions on the one hand, and the decisionmaking process on the other, may be seen as a special case of a recurrent legal tendency to review procedure much more intensively than substance.”).

91. This is commonly thought to be the effect of *Van Gorkom* and the reason that the Delaware legislature responded by eviscerating the duty of care in its aftermath. See Roberta

Favoring authority too often, however, would give directors little incentive to engage in good decisionmaking.<sup>92</sup> Some threat of intrusion and the imposition of director liability can serve to induce better fiduciary behavior and also award compensation to aggrieved shareholders when warranted.<sup>93</sup> Striking the right balance between authority and accountability in fiduciary duty litigation is essential to ensuring a well-functioning board,<sup>94</sup> and the individual/collective question speaks directly to that balance.

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

The collective approach, on the other hand, favors authority over accountability by deferring to the board's process. It only allows for judicial intervention and director liability in cases where a significant number of directors have breached their fiduciary duties. Because it allows a single

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Romano, *What Went Wrong with Directors' and Officers' Liability Insurance*, 14 DEL. J. CORP. L. 1, 1-2 (1989) (noting that the percentage of outside directors was decreasing by 1989); see also Bernard Black et al., *Outside Director Liability*, 58 STAN. L. REV. 1055, 1059 (2006). Black et al. argue:

Regardless of one's position on the [desirability of outside director liability], . . . all would agree that, beyond some level of liability risk, qualified people may decide not to serve as directors and that those who do serve may become excessively cautious. Too much fear of liability, therefore, may reduce rather than enhance the quality of board decisions.

*Id.*

92. This assumes that nonlegal sanctions alone cannot adequately police director misbehavior, a claim that some would dispute. See *supra* note 8.

93. See Fairfax, *supra* note 6, at 395 (“[L]egal liability represents an essential mechanism for ensuring directors’ fidelity to their fiduciary duties . . .”).

94. See Lyman Johnson, *After Enron: Remembering Loyalty Discourse in Corporate Law*, 28 DEL. J. CORP. L. 27, 27 (2003). Johnson states:

In a post-Enron world of corporate governance scandal and calls for reform, fiduciary duty law presents, as a policy matter, a possible state law-based approach for attaining greater director accountability. The wisdom of doing so will depend, in part, on whether the risk of greater financial exposure will induce enhanced discharge of director responsibilities, to the advantage of shareholders, or dissuade capable prospective director candidates from service, to the detriment of shareholders.

*Id.*

director's fiduciary breach to be ignored, the collective approach should be reserved for cases where that breach is not harmful enough to meaningfully taint the board's process and shake our confidence in its decision. In other words, a collective focus is appropriate where the board functions adequately despite the wrongdoing or lapse of an individual director.

Courts could, of course, use the collective approach to impose liability on the full board for the wrongdoing of even a single director, thereby enticing outside directors to monitor inside directors more carefully.<sup>95</sup> Daryl Levinson has argued that collective sanctions of this kind "make functional sense when group members have the capacity to monitor and control the behavior of some intuitively primary wrongdoer more efficiently than an external sanctioner."<sup>96</sup> Levinson notes that vicarious liability and joint and several liability are based on the idea of collective sanctions.<sup>97</sup> Although collective sanctions are an interesting theoretical possibility in fiduciary duty litigation, courts have not taken this approach. Rather, courts do not typically impose fiduciary liability on a full board for an individual director's breach.

In a recent empirical study, Bernard Black, Brian Cheffins, and Michael Klausner found only three cases in the past twenty-five years, including *Van Gorkom*, where outside directors made out-of-pocket payments for fiduciary duty breaches.<sup>98</sup> This low incidence of outside-director liability is partially because, *Van Gorkom* notwithstanding, less-culpable outside directors tend to

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95. The use of outside/independent directors as monitors is firmly established as corporate governance policy. In the wake of recent corporate scandals, the perceived importance of outside directors has received even more attention than in the past. See, e.g., James D. Cox, *Managing and Monitoring Conflicts of Interest: Empowering the Outside Directors with Independent Counsel*, 48 VILL. L. REV. 1077, 1078 (2003) ("It is safe to say that expectations for the independent director have never been higher than they are today."); Fisch, *supra* note 3, at 267 (discussing managerial versus monitoring boards); Sale, *supra* note 62, at 1376 n.4 (noting that the SEC now envisions a heightened role for independent directors as securities monitors).

96. Daryl J. Levinson, *Collective Sanctions*, 56 STAN. L. REV. 345, 426 (2003); see also CHRISTOPHER KUTZ, *COMPLICITY* 162 (2000). Mr. Kutz writes:

I suggest that those who contribute to collective acts on an ongoing basis will fall into the category of intentional participants so long as they see themselves as part of a collective act and whether or not they favor the collective goal. If so, they are subject to the inclusive ascription of collective acts.

*Id.*; cf. Note, *Collective Sanctions and Large Law Firm Discipline*, 118 HARV. L. REV. 2336 (2005) (applying the collective approach to behavior in a law-firm environment).

97. Levinson, *supra* note 96, at 362–70.

98. See Black et al., *supra* note 91, at 1068–76 (finding empirically that outside directors of public companies have made personal payments in only thirteen cases in the last twenty-five years, and only three of these thirteen case involved state law fiduciary duties). The authors did not count *Emerging Communications*, which, if outside director Muoio ended up making an out-of-pocket payment, would make the fourth case.

shield more-culpable inside directors from liability.<sup>99</sup> Under the collective approach, nonbreaching directors tend to protect breaching directors rather than vice versa. Therefore, a collective focus is not used to impose accountability through collective sanctions, but instead to reinforce the board's authority.

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

If achieving the proper balance between a board's authority and its accountability is the ideal in corporate governance, then it should have the most to say about our answer to the individual/collective question. However, the American Law Institute ("ALI") identifies two specific goals to be served by fiduciary duty litigation that must also be examined. First, fiduciary duty litigation is intended to deter fiduciary duty breaches *ex ante*; second, it is intended to compensate for the losses those breaches cause *ex post*.<sup>100</sup> While these goals have been delineated separately from the

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99. Outside/independent directors provide other legal benefits as well. A board's decision not to pursue a derivative action after demand, or a special litigation committee's decision to dismiss a suit after demand futility, is more likely to be protected by the business judgment rule if directors are disinterested and independent. *See generally* Aronson v. Lewis, 473 A.2d 805 (Del. 1984) (discussing demand futility); Zapata Corp. v. Maldonado, 430 A.2d 779 (Del. 1981) (discussing special litigation committees). Also, "the Delaware courts have held that the decisions of boards with a majority of outside directors are entitled to certain beneficial presumptions." Pease, *supra* note 64, at 35 (citing Puma v. Marriott, 283 A.2d 693 (Del. 1971), and takeover cases from the 1980s); *see also* Ivanhoe Partners v. Newport Mining Corp., 535 A.2d 1334, 1343 (Del. 1987) ("[W]ith the independent directors in the majority, proof that the board acted in good faith and upon reasonable investigation is materially enhanced."); Laura Lin, *The Effectiveness of Outside Directors as a Corporate Governance Mechanism: Theories and Evidence*, 90 NW. U. L. REV. 898, 963 (1996) ("[C]ourts may be more inclined to approve the board's actions if the board was composed of a majority of independent outside directors."). *See generally* Jeffrey N. Gordon, *The Rise of Independent Directors in the United States, 1950–2005: Of Shareholder Value and Stock Market Prices*, 59 STAN. L. REV. 1465 (2007) (examining the trend toward greater independence of directors).

100. *See* 2 AM. LAW INST., PRINCIPLES OF CORPORATE GOVERNANCE, pt. 7, introductory note, reporter's note 2, at 12 (1992) [hereinafter 2 ALI PRINCIPLES] ("As with other forms of tort actions, the derivative's action's principal goals are deterrence and compensation."). Although the ALI Principles discuss fiduciary litigation that takes the form of a derivative suit, these suits have now taken a backseat to shareholder class actions. *See* Robert B. Thompson & Randall S. Thomas, *The Public and Private Face of Derivative Lawsuits*, 57 VAND. L. REV. 1747, 1762 (2004) (noting that in Delaware in 1999 and 2000, 824 fiduciary duty suits were in the form of class actions, while only 137 were derivative suits). This is probably due to the derivative suit's demand requirement and to the mergers and acquisitions context in which these suits frequently arise, where shareholders can claim a direct injury. *See id.* at 1762 (noting that class actions avoid the "demand requirements and other procedural provisions that apply to derivative suit"). But the difference between derivative suits and class actions is of little consequence to the discussion at hand—the goals underlying derivative suits apply more or less equally to class actions. *See* 2 ALI PRINCIPLES, *supra*, pt. 7, introductory note, reporter's note 2, at 13 (stating that the deterrence rationale for derivative suits "applies as well to the context of shareholder litigation").

authority/accountability balance, the following discussion shows that they ultimately inform that balance rather than compete with it.

*a. Deterrence*

Many believe the deterrence of director wrongdoing to be a stronger rationale for allowing fiduciary duty suits than compensation.<sup>101</sup> The U.S. Supreme Court has remarked that even in cases where it “may be impossible to assign monetary value to the benefit,” fiduciary duty litigation can render “a substantial service to the corporation and its shareholders.”<sup>102</sup> It may be that fiduciary duty litigation itself is a weak deterrent compared with market and other non-legal forces acting on directors.<sup>103</sup> The availability of indemnification and D&O insurance, which serve to protect certain breaching directors from making personal payments, certainly reduces the deterrent effect of fiduciary duty suits.<sup>104</sup> Nevertheless, many believe the

101. See 2 ALI PRINCIPLES, *supra* note 100, pt. 7, introductory note, reporter’s note 3, at 16 (“[I]f meritorious derivative actions seeking to enforce legal rules that protect all shareholders could be easily terminated simply by showing that they would not yield a positive net recovery, average agency costs might rise . . . .”); James D. Cox, *Compensation, Deterrence, and the Market as Boundaries for Derivative Suit Procedures*, 52 GEO. WASH. L. REV. 745, 780 (1984). Cox states:

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

*Id.* (quoting 2 AM. LAW INST., PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 7.16(c) (1983)). *But see* Bangor Punta Operations, Inc. v. Bangor & Aroostook R.R. Co., 417 U.S. 703, 717 (1974) (denying a cause of action in a derivative suit in the absence of an injury because “[i]f deterrence were the only objective, then . . . any plaintiff willing to file a complaint would suffice”).

102. *Mills v. Elec. Auto-Lite Co.*, 396 U.S. 375, 396 (1970).

103. See 2 ALI PRINCIPLES, *supra* note 100, pt. 7, introductory note, at 5 (“[T]he derivative action is neither the initial nor the primary protection for shareholders against managerial misconduct. A variety of social and market forces also operate to hold corporate officials accountable . . .”).

104. Indemnification is available, provided the directors have acted in good faith and in the best interests of the corporation. DEL. CODE ANN. tit. 8, § 145 (2001) (limiting permissive indemnification to amounts paid by a director “if the person acted in good faith and in a manner the person reasonably believed to be in or not opposed to the best interests of the corporation”); *see also* Karl E. Strauss, Note, *Indemnification in Delaware: Balancing Policy Goals and Liabilities*, 29 DEL. J. CORP. L. 143, 155–65 (2004) (stating that indemnification serves to protect directors against personal exposure to liability). D&O insurance, which almost all public corporations have, provides a further backstop against personal liability. Because there are no limits imposed by corporate or securities laws on the scope of coverage, *see* Black et al., *supra* note 91, at 1085, D&O insurance should be able to fill any holes left by good faith exclusions in indemnification:

threat of fiduciary liability plays some role in deterring director wrongdoing, thereby reducing agency costs between shareholders and directors.<sup>105</sup> Consequently, some courts have allowed these suits to proceed even when damages are unavailable.<sup>106</sup>

The individual and collective approaches vary in their deterrent effects. The individual approach aims to deter each director on the board and penalizes even a single director's transgression. Consequently, the individual approach provides a harsh form of deterrence. It should therefore be reserved for cases where it is necessary for *every* director to act, or to refrain from acting, in a particular manner to ensure a reliable decisionmaking process. Of course, it is always *desirable* for each director to comply with her fiduciary duties, but the law must maintain a balance between deterring too little and overdetering to the point that directors do not take risks or serve on boards.<sup>107</sup> Again, the goal of corporate law generally, and of the choice of assessment approach specifically, is to maintain the balance between a board's authority and its accountability. By favoring accountability, the individual approach may provide optimal deterrence in some cases but not in others.

The collective approach, on the other hand, aims to deter the board as a whole. If courts used this approach as a collective sanction—to penalize

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[E]ven outside directors whose oversight failure is so extreme as to meet the good faith standard may still be covered by D&O insurance to the extent of the policy limit. . . . D&O policies exclude from coverage conduct that constitutes deliberate fraud or the taking of illegal profits. These exclusions are narrower than the conscious disregard of duty conception of good faith.

*Id.* at 1094 (citation omitted).

105. See Robert H. Sitkoff, *An Agency Costs Theory of Trust Law*, 89 CORNELL L. REV. 621, 638 (2004) (“[L]iability rules such as fiduciary duties . . . [are] devices for minimizing agency costs.”).

106. See *Diamond v. Oreamuno*, 248 N.E.2d 910, 912 (N.Y. 1969). The court stated:

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

*Id.* (citations omitted).

107. See 2 ALI PRINCIPLES, *supra* note 100, pt. 7, introductory note, at 8 (revealing that the ALI seeks “to steer a middle course between excessive reliance on litigation remedies and the abolition of any judicial recourse for the shareholder” and “is particularly sensitive to the danger of overdeterrence and the impact of even the potential risk of litigation on the willingness of outside directors to serve and on their conduct as directors”); see also *supra* note 91 and accompanying text (discussing the potential negative consequences of excessive liability risk for outside directors).

the whole board for the breaches of individual directors—it could serve as a harsh form of deterrence aimed at outside directors who fail to monitor inside directors. As noted earlier, however, the collective approach does not operate as a collective sanction in fiduciary duty law.<sup>108</sup> Instead, by requiring multiple breaches for judicial intervention, the collective approach is a weak form of deterrence that is appropriate where the concern is overdeterrence and where the public has confidence in the board’s decisionmaking process if *most* directors comply with their fiduciary duties. The collective approach strikes the authority/accountability balance in favor of a board’s authority, thereby assuming that there is less need for accountability.

*b. Compensation*

The other goal of fiduciary duty suits—compensation—is a less-important rationale than deterrence if we accept the conventional wisdom that holding directors to account provides minimal economic benefits to shareholders, with plaintiffs’ attorneys being the primary economic beneficiaries.<sup>109</sup> Whether or not the conventional wisdom is correct, the choice between an individual and collective focus impacts the likelihood of compensation. The individual director approach provides the most robust means of compensation, as even a single director’s fiduciary duty breach can trigger a recovery. The recovery is not diminished because it comes from only a single director, as breaching directors are jointly and severally liable for a plaintiff’s entire loss.<sup>110</sup> The collective approach, on the other hand,

108. See *supra* notes 95–97 and accompanying text.

109. For a list of critiques of the plaintiff’s attorney’s role in shareholder litigation, see Reinier Kraakman et al., *When Are Shareholder Suits in Shareholder Interests?*, 82 GEO. L.J. 1733, 1734 n.5 (1994) (collecting sources). But see Thomas M. Jones, *An Empirical Examination of the Resolution of Shareholder Derivative and Class Action Lawsuits*, 60 B.U. L. REV. 542, 545 (1980) (noting that plaintiff shareholders obtained recovery in approximately seventy-five percent of cases, but whether recovery exceeded costs of litigation was not measured). Additionally, as Robert Thompson and Randall Thomas have noted:

[R]oughly 30 percent of the derivative suits provide relief to the corporation or the shareholders, while the others are usually dismissed quickly with little apparent litigation activity. In cases producing a recovery to shareholders, the amount of recovery typically exceeds the amount of attorneys’ fees awarded by a significant margin.

Thompson & Thomas, *supra* note 100, at 1749–50. Shareholders prefer class actions to derivative suits as a means of compensation because any sums recovered derivatively go back to the corporate coffers, with shareholders compensated only indirectly through a pro rata increase in the value of their shares. See *id.* at 1758.

110. See *Trieweiler v. Sears*, 689 N.W.2d 807, 835 (Neb. 2004) (stating that, based on the principle that co-agents are jointly and severally liable, “it has been held that directors and officers of a corporation are jointly and severally liable if they jointly participate in a breach of fiduciary duty”); *Resolution Trust Corp. v. Block*, 924 S.W.2d 354, 355 (Tenn. 1996) (“While officers and directors’ liability to the corporation has been attributed to various legal theories, it has been unanimously recognized that officer and director liability to the corporation for their collective actions is joint and several.” (internal citation omitted)); *Smith v. Van Gorkom*, 488

makes compensation less likely by requiring a greater number of directors to breach to trigger recovery. As with deterrence, a court's choice between the two approaches should seek to appropriately compensate without overcompensating. To achieve this balance, courts should select the individual approach and award compensation in cases where a single director's breach is likely to be the proximate cause of a loss, but they should select the collective approach and deny compensation in cases where a single director's breach is unlikely to have caused the loss.<sup>111</sup>

### B. APPLICATION OF NORMATIVE CRITERIA TO FIDUCIARY DUTY CLAIMS

This Section now applies these normative criteria—striking the appropriate balance between a board's authority and accountability and furthering the twin goals of deterrence and compensation—to the different types of fiduciary duty claims that a plaintiff may bring. Doing so will reveal support for the duty-specific answer that courts have been providing to the individual/collective question.

#### 1. Duty of Loyalty

##### a. *Self-Dealing*

In choosing between the individual and collective approaches, classic duty of loyalty claims present the most straightforward analysis. As a general matter, a director breaches his duty of loyalty when he approves a corporate action that benefits himself at the shareholders' expense (so-called "self-dealing" transactions). To answer the individual/collective question, there are three things to note about self-dealing. First, it is intentional rather than negligent conduct. Second, it is typically done by inside directors, who may try to use their management positions and more intimate knowledge about the corporation to gain a personal benefit. Third, according to conventional wisdom, at least, these inside directors are likely to enjoy "board capture," meaning that outside directors are likely to "rubberstamp" any

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A.2d 858, 893 (Del. 1985) (imposing joint and several liability on all Trans Union directors); *In re Emerging Commc'ns, Inc. S'holders Litig.*, No. Civ.A. 16415, 2004 WL 1305745, at \*43 (Del. Ch. May 3, 2004) ("In the fiduciary duty action, defendants . . . are jointly and severally liable to the plaintiff class . . .").

111. Technically, only the board can cause a loss because no single director has the power to take action on behalf of the corporation. *See* RESTATEMENT (SECOND) OF AGENCY § 14C cmt. b (1958) ("An individual director . . . has no power of his own to act on the corporation's behalf, but only as one of the body of directors acting as a board."). However, the duty of loyalty rules essentially circumvent the board's role in the case of an undisclosed conflict of interest. If a single director has an undisclosed conflict, the only question is fairness. If a transaction is unfair, then only the single director is liable. This suggests that the single director is viewed as the proximate cause of the loss in such cases.

recommendations the insiders make.<sup>112</sup> When these three things are combined, it is clear that self-dealing has the potential to taint the board's decisionmaking process in a meaningful way—toward the self-dealing director's ends and away from the shareholders' ends.<sup>113</sup> Therefore, it is appropriate to favor accountability over authority in these situations to ensure a functional board. An individual approach allows courts to engage in a more extensive review of the board's process or the transaction's substantive merits and to impose liability on disloyal directors in unfair transactions.

CEO Prosser's conduct in *Emerging Communications* provides a good illustration of why an individual focus is appropriate in self-dealing cases.<sup>114</sup> Prosser engaged in self-dealing by scrapping a merger and instead pushing a privatization, a transaction from which he “‘derived an improper personal benefit.’”<sup>115</sup> Because he would reap a personal financial benefit from the privatization, Prosser had motive to induce the board to vote his way without adequate consideration of the shareholders' interests. Because he was an inside director who enjoyed board capture,<sup>116</sup> the board went along with his proposal. The Emerging Communications board failed to function properly as the result of a single director's disloyal.

Deterrence and compensation are also properly aimed at individual directors in self-dealing cases. Recall that by penalizing even a single director's fiduciary duty breach, the individual approach provides a stricter form of deterrence and a more likely means of compensation than does the collective approach. Assuming that intentional actors are more deterrable than negligent ones,<sup>117</sup> a stricter form of deterrence is appropriate for self-

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112. See CLARK, *supra* note 73, at 183 (detailing reasons why other directors might be beholden to a CEO); Bainbridge, *supra* note 83, at 105 (“In practice, of course, many boards of directors are captured by the firm's senior management and simply rubberstamp management decisions.”). Post-Sarbanes-Oxley, however, this tendency to rubberstamp may be lessening. See Lauren Etter, *Why Corporate Boardrooms Are in Turmoil*, WALL ST. J., Sept. 16, 2006, at A7 (“Corporate boards, which once served largely as rubber stamps for powerful CEOs, have become more independent, more powerful, and under more pressure to dump leaders who perform poorly.”).

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

114. See *supra* Part II.A.2 (discussing *In re Emerging Communications, Inc. Shareholders Litigation*).

115. *In re Emerging Commc'ns*, 2004 WL 1305745, at \*39.

116. *Id.* (noting that none of the other directors were independent of Prosser).

117. See Timothy Stoltzfus Jost & Sharon L. Davies, *The Empire Strikes Back: A Critique of the Backlash Against Fraud and Abuse Enforcement*, 51 ALA. L. REV. 239, 295 (1999) (“Where . . . the law imposes criminal sanctions or civil penalties on intentional conduct . . . complete deterrence is a proper goal. An intentional actor, by definition, acts with more deliberation and

dealing. Likewise, given that the law favors harsher financial penalties for intentional actors than for negligent ones,<sup>118</sup> a greater likelihood of damages is appropriate for disloyalty. Further, overdeterrence and overcompensation are less of a concern for intentional wrongs, such as self-dealing, particularly because a director's disloyalty does not automatically result in liability. As an initial matter, disloyalty serves only to rebut the presumptions of the business judgment rule and trigger judicial scrutiny of a challenged transaction. The law's saving mechanisms, particularly entire fairness, will help keep deterrence and compensation in check when courts apply the individual approach in self-dealing cases.<sup>119</sup> If a court ultimately assesses liability, typically the penalty only will be disgorgement of the ill-gotten gains.<sup>120</sup>

### b. Good Faith

The precise nature of good faith has been in flux in the Delaware courts for some time now. Before the Delaware Supreme Court took up the issue in *Disney* and most recently in *Stone v. Ritter*,<sup>121</sup> it was unclear whether good faith was inextricably tied to the duty of loyalty, the duty of care, or whether it constituted a third, independent fiduciary duty on equal footing with the other two. Scholars had found support for each of these positions. For example, Sean Griffith cited "[s]everal closely reasoned chancery court opinions [that] treat good faith as an aspect of the duty of loyalty," including *Emerging Communications*.<sup>122</sup> Some opinions, including the Chancery Court's opinion in *Disney*, had been read to suggest a good faith/due care interplay.<sup>123</sup> And Hillary Sale, most notably, had argued that recent Delaware

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therefore should be more deterrable than a negligent actor."). *But see* GUIDO CALABRESI, *THE COSTS OF ACCIDENTS* 133–73 (1970) ("Negligent, no less than intentional, wrongs are fit subjects for deterrence."); Donald C. Langevoort, *Ego, Human Behavior, and Law*, 81 VA. L. REV. 853, 869 (1995) (suggesting that the egos of corporate managers can cause them to underestimate the risks or the wrongfulness of their actions, thereby weakening the deterrent value of legal sanctions).

118. *See* WILLIAM PROSSER, *HANDBOOK ON THE LAW OF TORTS* 30–31 (4th ed. 1971) (noting that greater liability is imposed on the intentional tortfeasor than on the negligent one).

119. *See supra* notes 73–74 and accompanying text (discussing various ways to save a self-dealing transaction).

120. *See supra* note 74 and accompanying text (discussing restitutionary and rescissory damages in self-dealing cases).

121. *Stone v. Ritter*, 911 A.2d 362 (Del. 2006).

122. Griffith, *supra* note 44, at 5 n.11 (citing cases); *see also* Johnson, *supra* note 94, at 55 ("Delaware courts have branded conduct falling with the second ('not in good faith') exception [to Section 102(b)(7)] as implicating loyalty . . .").

123. Griffith observed that Chancellor Chandler focused on the board's *process* in approving the Ovitz employment agreement, which is essentially a due care analysis, under the rubric of good faith. Griffith, *supra* note 44, at 22–23 ("As in *Van Gorkom*, such allegations would typically form the basis of the complaint under the duty of care, but the court did not pursue this analysis, perhaps because the business judgment rule and the 102(b)(7) provision would have kept it from getting very far."). Hillary Sale noted the interplay between good faith and

decisions laid the groundwork for recognizing good faith as an independent fiduciary duty.<sup>124</sup>

In *Disney*, the Delaware Supreme Court appeared to establish good faith as an independent fiduciary duty. The court first noted that, despite the recent scholarly writing on the subject, “the duty to act in good faith is, up to this point, relatively unchartered.”<sup>125</sup> Then it stated that “the universe of fiduciary misconduct is not limited to either disloyalty in the classic sense . . . or gross negligence. A vehicle is needed to address such violations doctrinally, and that doctrinal vehicle is the duty to act in good faith.”<sup>126</sup> Curiously, however, after discussing a duty of good faith and what it entailed, the court hedged in a final footnote reading:

[W]e do not reach or otherwise address the issue of whether the fiduciary duty to act in good faith is a duty that, like the duties of care and loyalty, can serve as an independent basis for imposing liability upon corporate officers and directors. That issue is not before us on this appeal.<sup>127</sup>

The reason for the court’s hedge became clear in *Stone*, a decision issued less than five months after the court’s opinion in *Disney*. In *Stone*, the court surprisingly reversed course and, with scant explanation, held that good faith was not an independent fiduciary duty, but part of the duty of loyalty.<sup>128</sup> *Stone* was interesting in another respect, for not only did it put good faith under the loyalty heading, but it put the famous *Caremark* “duty to monitor” case,<sup>129</sup> which was widely seen as a subset of the duty of care,<sup>130</sup> under the loyalty heading as well.

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due care in another well-known Delaware case, *In re Caremark International Inc. Derivative Litigation*. Sale, *supra* note 5, at 467 (“*Caremark* generated considerable discussion as a duty of care case when issued. It remains an important contribution to the perceived standards of care, but arguably is also one of the cases discussing good faith explicitly in the context of corporate decisionmaking.”).

124. See Sale, *supra* note 5 at 482–94 (discussing good faith as a separate duty); Veasey with Di Guglielmo, *supra* note 59, at 1452 (“Professor Hillary Sale . . . has concluded rather convincingly that good faith is a separate fiduciary duty.”). On the emergence of the duty of good faith, see generally Tara L. Dunn, *The Developing Theory of Good Faith in Director Conduct: Are Delaware Courts Ready to Force Corporate Directors To Go Out-of-Pocket After Disney IV*, 83 DENV. U. L. REV. 531 (2005) (discussing the development of Delaware’s good faith jurisprudence); Eisenberg, *supra* note 5 (discussing the duty of good faith); David H. Cook, Comment, *The Emergence of Delaware’s Good Faith Fiduciary Duty: In re Emerging Communications, Inc. Shareholders Litigation*, 43 DUQ. L. REV. 91 (2004) (same).

125. *In re The Walt Disney Co. Derivative Litig. (Disney V)*, 906 A.2d 27, 64 (Del. 2006).

126. *Id.* at 66

127. *Id.* at 67 n.112.

128. See *Stone v. Ritter*, 911 A.2d 362, 370 (Del. 2006) (stating that “the obligation to act in good faith does not establish an independent fiduciary duty” but that the duty of loyalty “encompasses cases where the fiduciary fails to act in good faith”).

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

While the good faith jurisprudence of late is somewhat strange, good faith as defined by *Disney* (and affirmed by *Stone*) does more closely resemble the traditional duty of loyalty than the duty of care.<sup>131</sup> In *Disney*, the Delaware Supreme Court identified at least three types of bad-faith conduct: (1) intentionally acting with a purpose other than that of advancing the best interests of the corporation, (2) intentionally acting to violate applicable positive law, and (3) acting with a conscious and intentional disregard of duties.<sup>132</sup> The first two categories of subjective bad faith are “fiduciary conduct motivated by an actual intent to do harm,”<sup>133</sup> to which the court remarked that “[the fact that] such conduct constitutes classic, quintessential bad faith is a proposition so well accepted in the liturgy of fiduciary law that it borders on axiomatic.”<sup>134</sup> The third category, a “conscious and intentional disregard of duties,” is a somewhat less obvious type of bad faith and may have the potential to expand the range of proscribed fiduciary conduct.<sup>135</sup>

For purposes of the individual/collective question, the most important thing to note is that a fiduciary’s bad faith is currently limited to *intentional* misconduct, whichever of the three types is implicated.<sup>136</sup> Some corporate law scholars would critique *Disney* and *Stone* as defining bad faith too narrowly, and they would extend the definition to include egregious acts or derelictions of duty that fall short of intentional misconduct.<sup>137</sup>

At least as things stand now, however, the main reason for using an individual director approach in classic disloyalty cases—the intentional

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

131. See *Disney V*, 906 A.2d at 63–64 (rejecting a conflation of the duties of good faith and care).

132. *Id.* at 67.

133. *Id.* at 64.

134. *Id.*

135. See *id.* at 66 (“To protect the interests of the corporation and its shareholders, fiduciary conduct . . . , which does not involve disloyalty (as traditionally defined) but is qualitatively more culpable than gross negligence, should be proscribed.”).

136. For a post-*Disney* opinion emphasizing the intentionality requirement in bad faith, see *ATM-KIM Eng Fin. Corp. v. Araneta*, No. CIV.A. 489-N, 2006 WL 3783520, at \*19 (Del. Ch. Dec. 21, 2006) (“[I]mposition of liability requires a showing that the directors knew that they were not discharging their fiduciary obligations.”), and *id.* at \*21 (stating that the behavior of two directors who failed to monitor inside director and majority shareholder’s self-dealing “was not the product of a lapse in attention or judgment; it was the product of the willingness to serve the needs of their employer . . . even when that meant intentionally abandoning the important obligations they had taken on”).

137. See Sale, *supra* note 5, at 493 (arguing that “a breach of good faith need not be intentional or conscious” but “does require some sort of obvious, deliberate, or egregious failure”). See generally Elizabeth A. Nowicki, *Not in Good Faith*, 60 SMU L. REV. 441 (2007) (arguing that actions taken by directors that are “not in good faith,” whether or not they constitute bad faith, should be deemed breaches of fiduciary duty).

nature of self-dealing—suggests that the individual approach should also apply in the new subset of good faith cases. Because bad faith on the part of even one director might inject a harmful bias into the board's decisionmaking process, courts should favor accountability over authority, and the stricter form of deterrence and compensation, in good faith cases.

## 2. Duty of Care

Duty of care claims present a more difficult choice between the individual and collective approaches.<sup>138</sup> Legally, acting with due care means avoiding gross negligence.<sup>139</sup> Practically, it means becoming informed, weighing decisions, and consulting with the appropriate advisors.<sup>140</sup> Despite Delaware's passage of Section 102(b)(7), which allows corporations to exculpate directors from personal liability for duty of care breaches,<sup>141</sup> due care claims may well survive a motion to dismiss and call for a choice between the individual and collective approaches after trial. Current law on Section 102(b)(7) exculpation allows for dismissal of a plaintiff's complaint

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

139. See *In re The Walt Disney Co. Derivative Litig. (Disney IV)*, 907 A.2d 693, 750 (Del. Ch. 2005) ("[D]uty of care violations are actionable only if the directors acted with gross negligence . . . ." (citation omitted)).

140. See Sale, *supra* note 5, at 466 (discussing these actions as necessary to fulfill directors' responsibilities under the duty of care).

141. DEL. CODE ANN. tit. 8, § 102(b)(7) (2001). Under this provision, a certificate of incorporation may contain:

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

*Id.*

Most states have passed legislation similar to Section 102(b)(7). See ROBERT W. HAMILTON, *CASES & MATERIALS ON CORPORATIONS INCLUDING PARTNERSHIPS AND LIMITED LIABILITY COMPANIES* 783 (7th ed. 2001) (stating that by 1999, forty-three states had passed such legislation); Romano, *supra* note 91, at 30–32 (indicating that by 1987, thirty states had passed legislation allowing shareholders to opt into similar protections for directors). Virtually all large U.S. corporations have opted in favor of these protections. See Lawrence A. Hamermesh, *Why I Do Not Teach Van Gorkom*, 34 GA. L. REV. 477 app. A (1999) (finding that in a survey of one hundred large U.S. corporations, only seven did not opt for this protection). *But see* Eisenberg, *supra* note 5, at 64–65 (contending that Section 102(b)(7) and similar provisions have important exceptions).

when only due care violations are raised.<sup>142</sup> Therefore, a complaint that also alleges disloyalty or bad faith should preserve the plaintiff's case for trial, given that bad faith or disloyalty can rebut the protective presumptions of the business judgment rule and void a Section 102(b)(7) clause.<sup>143</sup> In addition, Section 102(b)(7) clauses do not preclude a choice between the individual and collective approaches in assessing duty of care violations for purposes of granting injunctive relief.<sup>144</sup>

The lack of due care is a wrong of a different nature than disloyalty because it is not intentional. Bainbridge discusses this difference:

[L]oyalty . . . differ[s] in kind, not just in degree, from care. . . . [T]here is a compelling economic justification for insulating allegedly negligent board decisions from judicial review. Few components of that justification carry over to self-dealing. Indeed, the affirmative case for disregarding honest errors simply does not apply to intentional misconduct.<sup>145</sup>

Likewise, Alison Anderson has remarked that disloyalty may be considered more "unfair" than negligence because it entails a "more deliberate form of self-preference."<sup>146</sup> The Delaware Supreme Court also made this distinction clear in *Disney*, explaining that:

Basic to the common law of torts is the distinction between conduct that is negligent (or grossly negligent) and conduct that is intentional. And in the narrower area of corporation law, our jurisprudence has recognized the distinction between the fiduciary

142. See Sale, *supra* note 5, at 467 & n.62 (citing cases).

143. Under Section 102(b)(7), a certificate of incorporation may not limit or eliminate a director's personal liability for "any breach of the director's duty of loyalty . . . acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law . . . or . . . for any transaction from which the director derived an improper personal benefit." DEL. CODE ANN. tit. 8, § 102(b)(7) (2001); see also Veasey with Di Guglielmo, *supra* note 59, at 1441-42 ("[I]f directors 'consciously and intentionally disregarded their responsibilities,' they have not acted in good faith and their conduct will not be protected by the business judgment rule or by section 102(b)(7).").

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

145. STEPHEN M. BAINBRIDGE, CORPORATION LAW AND ECONOMICS 306 (2002).

146. Alison Anderson, *Conflicts of Interest: Efficiency, Fairness and Corporate Structure*, 25 UCLA L. REV. 738, 758 n.59 (1978); see also Johnson, *supra* note 94, at 60 n.191 ("The element of deliberateness may, as the vice chancellor [Leo Strine] suggests, serve as one partial 'marker' for identifying conduct as raising a loyalty issue for purposes of sanctioning inappropriate conduct.").

duties to act with due care, with loyalty, and in good faith, as well as the consequences that flow from that distinction.<sup>147</sup>

Whether a director's wrongdoing is intentional or unintentional has important ramifications for the board's decisionmaking process. There is a more harmful and pervasive quality to a director's intentional wrongdoing than to her carelessness. Directors acting intentionally have motive to subvert the board's process to win approval of a transaction that imbues benefits to themselves, in cases of disloyalty, or to allow their fellow directors to subvert the process, in some cases of bad faith.<sup>148</sup> Directors acting negligently, on the other hand, are less likely to even participate in the deliberation process given their lack of information about the matters under discussion.<sup>149</sup> By analogy, it is almost as though the negligent director was absent from the board meeting. Yet majority rule permits boards to make decisions and take action without the participation or vote of all directors.<sup>150</sup> Given majority rule, and assuming that a grossly negligent director does little more harm in a meeting through her carelessness than an absentee director does through her absence, the board's process is less affected by a single director acting negligently than one acting intentionally.

Another important difference in the due care setting is the status of the director who is likely to engage in the misconduct. Inside directors are more likely to have conflicts of interest because they serve the corporation full-time to the exclusion of other professional pursuits.<sup>151</sup> On the other hand, they are less likely to be uninformed or otherwise careless due to their more

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147. *In re The Walt Disney Co. Derivative Litig. (Disney V)*, 906 A.2d 27, 67 n.109 (Del. 2006). Recognition that intentional wrongdoing has a different and more culpable nature than negligence also underlies important provisions of U.S. securities law. *See Sale, supra* note 5, at 489 ("Scienter is a key element of claims pursuant to section 10(b) of the 1934 Securities Exchange Act and the accompanying Rule 10b-5 . . ." (internal citations omitted)).

148. For instance, in *Emerging Communications*, the court acknowledged that attorney/director Raynor may not technically have been disloyal, in the classic self-dealing sense, because he did not directly profit from the privatization transaction, but his complete financial reliance on CEO Prosser—who did directly profit—indicated bad faith. *In re Emerging Commc'ns, Inc. S'holders Litig.*, No. Civ.A 16415, 2004 WL 1305745, at \*39 & nn.183–84 (Del. Ch. May 3, 2004). Similarly, although financial expert/director Muoio was not technically disloyal, neither was he independent of Prosser. The court found that this lack of independence, coupled with the fact that the privatization price should have seemed dubious to someone with Muoio's financial expertise, indicated bad faith. *Id.* at \*39.

149. Joseph Bonito, a professor of communications who studies participation in small groups, makes this observation. *See* Joseph A. Bonito, *An Information-Processing Approach to Participation in Small Groups*, 28 COMM. RES. 275, 279 (2001) ("[T]he more task-relevant information a member possesses, the greater the likelihood that he or she will contribute to the discussion.").

150. *See supra* note 9 and accompanying text.

151. *See supra* note 62 and accompanying text (distinguishing between inside and outside directors).

intimate knowledge of corporate affairs.<sup>152</sup> Outside directors present the flip side of the coin. They are less likely to have conflicts of interest, but they are more likely to be careless because they devote less attention to the corporation.<sup>153</sup> Despite recent efforts to make outside directors more effective monitors, inside directors continue to enjoy informational and other advantages.<sup>154</sup> For these reasons, outside directors commonly defer to inside directors during deliberations.<sup>155</sup> Given that inside directors shape the board's deliberations, their fiduciary duty breaches merit greater attention.<sup>156</sup>

If due care breaches are less severe in nature because they involve silent ignorance on the part of less influential outside directors, as opposed to

152. See Roberta Romano, *The Shareholder Suit: Litigation Without Foundation?*, in FOUNDATIONS OF CORPORATE LAW 170, 178 (1993) ("The larger management's [stock ownership in the corporation], the more closely its incentives are aligned with the interest of other shareholders.").

153. See R. Link Newcomb, Note, *The Limitation of Directors' Liability: A Proposal for Legislative Reform*, 66 TEX. L. REV. 411, 426 (1987) ("[O]utside directors, who are typically without conflicts of interest, must satisfy only a duty of care.").

154. Professor Dallas explains:

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

Lynne L. Dallas, *The Relational Board: Three Theories of Corporate Boards of Directors*, 22 J. CORP. L. 1, 4-5 (1996) (internal citation omitted).

155. See Alan J. Meese, *The Team Production Theory of Corporate Law: A Critical Assessment*, 43 WM. & MARY L. REV. 1629, 1699-1700 (2002) ("[B]y virtue of his or her dominant position within the firm, and position as Chairman of the Board, the CEO can influence, if not control outright, the selection of inside and outside directors. Further, the CEO and other prominent officers are able to control the direction of the board." (internal citation omitted)).

156. Recognizing a higher standard of care for officers would be one way to account for this problem. See Lyman P.Q. Johnson & David Millon, *Recalling Why Corporate Officers Are Fiduciaries*, 46 WM. & MARY L. REV. 1597, 1642 (2005) ("There are fewer policy justifications for applying the business judgment rule to officers than directors, just as there are policy factors supporting greater liability risk for officers, compared to directors." (internal citation omitted)). Additionally, Professor Wade has noted:

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

Wade, *supra* note 6, at 770.

active subversion by more influential inside directors, then we should have confidence in a board's decisionmaking process if *most*, even if not all, directors fulfilled their duty of care. Accordingly, allowing consequences to flow from a single director's carelessness would permit too much judicial intrusion into the board's process, and courts should therefore select the collective approach to assess duty of care claims. In terms of our other normative criteria, aiming deterrence and compensation at individual directors in the due care setting should not matter much in light of Section 102(b)(7).<sup>157</sup> Because the available remedy for most due care breaches is now limited to injunctive relief,<sup>158</sup> the fear of personal liability should not deter directors from acting carelessly. Section 102(b)(7) also makes compensating shareholders for due care breaches far less likely.

Although the discussion thus far has been limited to ways in which the individual and collective approaches strike the board's authority/accountability balance and further the deterrence and compensation goals underlying fiduciary duty suits, it is also important to consider additional negative effects on the board's functioning that could result from using the individual approach in the due care setting. The consensus-driven decisionmaking process that now exists<sup>159</sup> could turn into a process that pits directors against each other (e.g., one director claiming that other directors withheld relevant information) to avoid culpability.<sup>160</sup> Board minutes might become more detailed to show the role that each director played in deliberations, thereby refocusing the directors' attention on personal perseverance rather than the business of the corporation at hand.<sup>161</sup> In cases that go to trial, directors facing individual treatment might request separate counsel due to their individual exposure. This would add to the cost of corporate reimbursement for directors' attorneys' fees and could make trials unruly, given an average board size of seven to nine directors.<sup>162</sup> An individual focus could also require courts to itemize and account for

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157. See *supra* notes 141–42 and accompanying text (discussing the exculpatory provisions of Section 102(b)(7)).

158. See *supra* note 144 and accompanying text (discussing Section 102(b)(7) clauses in the context of injunctive relief).

159. See *supra* note 10 (citing sources on board decisionmaking by consensus).

160. Critics of the move toward greater director independence note the advantages of a collegial board. See Usha Rodrigues, *The Fetishization of Independence*, 33 J. CORP. L. 447 (2008); Ideoblog, *Pretextinggate and the Independent Board*, <http://busmovie.typepad.com/ideoblog/> (Sept. 11, 2006, 8:59 CST) (“Board independence introduces a barrier between the managers and the monitors.”).

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

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

individual differences among directors (including a director's insider/outsider status and expert/nonexpert qualifications<sup>163</sup>) to assess due care compliance. As a result, both board and judicial efficiency would suffer if an individual approach were applied in duty of care cases. Finally, it is unclear whether an individual approach would be viable for assessing due care breaches, as it might be difficult to establish that the careless director was the proximate cause of any harm.

None of this is to suggest that we should not be concerned with a single director's carelessness or that we should excuse outside directors who do not monitor.<sup>164</sup> The possibility exists that one negligent director, had she been sufficiently informed, could have swayed the board's vote toward an advisable course of action. This hypothetical scenario unfolds in the classic movie *12 Angry Men*,<sup>165</sup> albeit in the jury room rather than the boardroom. In that movie, Henry Fonda is the only juror who believes—correctly, it turns out—that a criminal defendant is not guilty. He ends up convincing the other jurors, and the jury makes the right decision—to acquit. Anecdotal evidence indicates that even one director can have the same type of effect in a boardroom.<sup>166</sup> While this may be a tempting reason to favor an individual approach in the due care setting, on balance this approach would do more harm than good by penalizing isolated cases of negligence even if the board as a whole functioned adequately.

A final question must be asked before discussing what a duty-specific answer to the individual/collective question can tell us about fiduciary duties more generally: how is a preference for the collective approach in duty of care cases affected, if at all, by delegation to a board committee?<sup>167</sup> Specifically, to what extent should the full board, which later approves the committee's recommendation, be allowed to rely on the due care exercised by the committee as opposed to its own due care? On the one hand,

163. See *supra* notes 61–71 and accompanying text (discussing insider versus outsider status and expert versus nonexpert qualifications for directors).

164. Section 11 of the federal Securities Act could be seen as adopting an individual approach for unintentional acts. Section 11 imposes liability on outside directors for material misstatements or omissions in registration statements, yet it provides them with an individualized due diligence defense. See 15 U.S.C. § 77(k)(b) (2000) (codifying the exemption from liability upon proof of issues); Sale, *supra* note 62, at 1391 (“[D]irectors who are active and engaged, who ask questions, and who vet before signing, will not be liable.”). See generally William K. Sjostrom, Jr., *The Due Diligence Defense Under Section 11 of the Securities Act of 1933*, 44 BRANDEIS L.J. 549 (2006).

165. 12 ANGRY MEN (Metro Goldwyn Mayer/United Artists 1957).

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

167. On board committees and their roles, see April Klein, *Firm Performance and Board Committee Structure*, 41 J.L. & ECON. 275, 277–78 (1998).

corporate law allows boards to establish and delegate to committees,<sup>168</sup> and the board's decision to delegate is protected by the business judgment rule.<sup>169</sup> On the other hand, Bainbridge has identified social science literature that touts the desirability of group decisionmaking, suggesting that we should be hesitant to allow too much delegation if a committee's membership is too small to preserve these benefits.<sup>170</sup> On balance, because a committee is likely to have greater knowledge and expertise of matters within its purview, and because it is an accepted part of the corporate governance mechanism, it may be advisable to allow a properly functioning committee to exercise care on behalf of the full board.<sup>171</sup> On the other hand, the decision might depend on the size of the committee and perhaps the gravity of the matter under review.<sup>172</sup>

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168. See DEL. CODE ANN. tit. 8, § 141(c) (2001 & Supp. 2006) (allowing such delegation); MODEL BUS. CORP. ACT § 8.25 (2002).

169. The Delaware Supreme Court has stated:

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

Rosenblatt v. Getty Oil Co., 493 A.2d 929, 943 (Del. 1985) (citation omitted).

170. See Bainbridge, *supra* note 162, at 12–19; cf. Franklin A. Gevurtz, *The Historical and Political Origins of the Corporate Board of Directors*, 33 HOFSTRA L. REV. 89, 96–97 (2004). Gevurtz states:

[W]hile the multiple input found in groups often leads to superior decisions than made by a single individual, it is less clear from experimental studies of group decision-making whether this requires the group to act as peers, with disagreements ultimately resolved by majority rule, rather than as a "cabinet" to a single person who has the final say.

*Id.* The countervailing fear is that groupthink will become prevalent. See Bainbridge, *supra* note 162, at 32.

171. On the benefits of committees, see generally Anup Agrawal & Shiba Chadha, *Corporate Governance and Accounting Scandals*, 48 J.L. & ECON. 371 (2005) (finding empirically that audit committees having an independent director with financial expertise issue fewer financial restatements).

172. Both Delaware law and the MBCA permit a committee to be comprised of a single person. DEL. CODE ANN. tit. 8, § 141(c)(1) (2001) ("The board of directors may, by resolution passed by a majority of the whole board, designate 1 or more committees, each committee to consist of 1 or more of the directors of the corporation."); MODEL BUS. CORP. ACT § 8.25(a) (2002) ("[A] board of directors may create one or more committees and appoint one or more members of the board of directors to serve on any such committee."). If this is the case, the committee's due care probably should not be a substitute for the board's due care.

## IV. BROADER OBSERVATIONS ABOUT FIDUCIARY DUTIES

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

The courts' focus on individual directors in loyalty cases, contrasted with their focus on the board as a whole in due care cases, permits several important observations about fiduciary duties. First, it reveals that the divide between the traditional duties of care and loyalty is even wider than presently acknowledged. Recovery for duty of care breaches is highly unlikely due to the protective provisions of the business judgment rule and the widespread adoption of Section 102(b)(7) exculpation clauses.<sup>173</sup> Indeed, by finding no due care violations even in a case like *Disney* that involved highly lax director behavior, the Delaware Supreme Court reaffirmed *Van Gorkom's* status as an outlier in corporate law. If a collective approach to assessing liability requires several grossly negligent directors, rather than just one, it makes the possibility of recovery all the more remote. On the other hand, plaintiffs are generally more successful in classic duty of loyalty claims,<sup>174</sup> and the stricter individual director approach further tips the scales in plaintiffs' favor. Consequently, this contextualized choice of assessment approach reveals a further splintering between the duties of care and loyalty, with courts significantly more likely to impose liability for disloyalty while leaving problems of carelessness to market, reputational, and social sanctions.<sup>175</sup>

Second, this Article began by noting that fiduciary duty law currently serves as a weak mechanism for policing directors and that several corporate law scholars have argued in favor of more robust fiduciary law in the wake of

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173. See *supra* notes 141–44 and accompanying text.

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

175. On reputational and social sanctions, see Eisenberg, *supra* note 74, at 1276 ("The social norm of loyalty . . . adds the sanction of loss of reputation to the legal sanctions."); Einer Elhauge, *Sacrificing Corporate Profits in the Public Interest*, 80 N.Y.U. L. REV. 733, 747–56 (2005) ("Even when legal remedies would not suffice to deter us from engaging in certain undesirable conduct, we might hesitate from doing so because our reputation would suffer, causing others to stop doing business with us."); Daniel Fischel, *The Corporate Governance Movement*, 35 VAND. L. REV. 1259, 1287–90 (1982) (arguing that market forces influence director behavior); Edward B. Rock, *Saints and Sinners: How Does Delaware Corporate Law Work?*, 44 UCLA L. REV. 1009, 1011–12 (1997) ("[I]f managers mismanage, the stock price will drop . . . and a takeover entrepreneur will . . . replac[e] bad managers with good managers.").

recent corporate scandals.<sup>176</sup> If due care liability will not be revived—and *Disney* along with exculpation statutes suggest that it will not be—another hope for achieving this result is a more explicit duty to act in good faith that could expand or supplement the traditional duties.<sup>177</sup> Although the Delaware Supreme Court recently has been more explicit about a requirement to act in good faith, it has narrowly defined bad faith to include only intentional misconduct.<sup>178</sup> Thus, while good faith might expand somewhat the grasp of fiduciary law, all unintentional misconduct still appears to be out of reach. By putting good faith on the loyalty side of the dividing line, the court reaffirmed that fiduciary law is meant to penalize only the most egregious offenders through legal sanctions. Judicial use of an individual approach in these “extreme” cases, compared to a collective approach in all other cases, further assures this separation. Importantly, it also reveals a judicial de-emphasis on fiduciary liability as a corporate governance mechanism.

Finally, if courts are dividing the world of fiduciary liability into intentional and unintentional cases, using an individual or collective focus as their tool, why are they not more explicit about this? Each fiduciary duty suit that goes to trial requires a judicial choice between the individual and collective approaches, either explicitly or implicitly. But recall that only three major cases—*Van Gorkom*, *Emerging Communications*, and *Disney*—explicitly speak to this question, and then only superficially.<sup>179</sup> When implicit cases are considered, loyalty’s preference for the individual approach is easier to see than due care’s preference for the collective approach.<sup>180</sup> The question becomes this: have courts overlooked the importance of the individual/collective choice in duty of care cases, or is there a reason for only an implicit, or unspoken, preference?

The answer might be found in an important discussion distinguishing corporate law’s “standards of conduct” from its “standards of liability.”<sup>181</sup> Melvin Eisenberg and Gordon Smith have both observed that standards of conduct tell directors how to behave, while standards of liability tell judges

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176. See *supra* note 6 and accompanying text (citing scholars’ theories on increasing director accountability).

177. See *supra* note 5 and accompanying text (explaining scholars’ justifications for arguing in favor of “an independent duty of good faith”).

178. See *supra* notes 132–36 and accompanying text (explaining the Delaware Supreme Court’s analysis of “three types of bad-faith conduct”).

179. See *supra* Part II.A.

180. See *supra* Part II.B.

181. See generally Melvin Aron Eisenberg, *The Divergence of Standards of Conduct and Standards of Review in Corporate Law*, 62 FORDHAM L. REV. 437 (1993); Smith, *supra* note 79. This corporate law discussion stemmed from an important article by Meir Dan-Cohen separating “decision rules” from “conduct rules” in the criminal context. Meir Dan-Cohen, *Decision Rules and Conduct Rules: On Acoustic Separation in Criminal Law*, 97 HARV. L. REV. 625 (1984).

when to impose liability for director misbehavior.<sup>182</sup> There can be a significant distance between standards of conduct and standards of liability, as illustrated by the duty of care.<sup>183</sup> The standard of conduct tells directors to act with “due care,” which is “the care that an ordinarily prudent person would reasonably be expected to exercise in a like position and under similar circumstances.”<sup>184</sup> But the standard of liability tells judges to assess liability (or grant injunctive relief) only when the directors’ actions are irrational—i.e., not a valid exercise of business judgment.<sup>185</sup> A bifurcated structure thus encourages best practices, but only penalizes unacceptable practices.<sup>186</sup> It desires a board that functions perfectly, penalizes a board that functions inadequately, and tolerates a board that falls somewhere in between.

This bifurcated structure fails to work, however, when directors “hear” what is meant to be heard only by judges—i.e., standards of liability instead of standards of conduct. Directors who hear more lax standards of liability may be less likely to strive for higher standards of conduct. To maintain bifurcation, at least to the extent possible in the real world, standards of conduct should be made clear, while standards of liability should be obfuscated.<sup>187</sup> Accordingly, an explicit adoption of the collective approach in the due care context would run the risk of being heard by directors, thereby telling them of an important barrier to liability. For this reason, Smith rightly critiques the MBCA’s explicit adoption of the collective approach,

182. See Eisenberg, *supra* note 181, at 465; Smith, *supra* note 79, at 1204.

183. Eisenberg also observes a distance between the standards of conduct and standards of review in the case of the duty of loyalty. Eisenberg, *supra* note 181, at 464 (“In the area of loyalty . . . the law’s command to directors and officers is the standard of conduct, ‘deal fairly when you deal in your own self-interest,’ not the standard of review, ‘deal as you need to deal to get approval by your colleagues.’”).

184. See 1 AM. LAW INST., PRINCIPLES OF CORPORATE GOVERNANCE § 4.01 (a) (1992).

185. Eisenberg states:

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

Eisenberg, *supra* note 181, at 445–46.

186. As Chancellor Chandler reaffirmed in *Disney*, actual practices can fall far short of best practices without the imposition of liability. *In re The Walt Disney Co. Derivative Litig. (Disney IV)*, 907 A.2d 693, 697–98 (Del. Ch. 2005).

187. Eisenberg, *supra* note 181, at 466 (“[S]tandards of conduct . . . should be simple, so that they can be effectively communicated, and to the extent possible should reflect social norms of upright business behavior that directors and officers can be expected to know even if they do not know the law.”); *id.* (“[S]tandards of review may rest on social propositions other than norms of upright business behavior, and correspondingly may be formulated in a more complex manner than standards of conduct.”).

noting that “[b]y shifting the focus from the individual director to the board as a collegial body, the MBCA *dampens the force of its command*.”<sup>188</sup> Delaware courts, on the other hand, presciently maintain “vagueness in enunciating the decision rule”<sup>189</sup> by only implicitly adopting the collective approach.

## V. CONCLUSION

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

While this Article has provided a framework for answering the individual/collective question, it has also left some important questions unanswered. For instance, the judicial opinions that were the focus of this Article were rendered after a full trial on the merits. Many fiduciary duty cases do not make it this far, however, which leaves the question as to whether the individual/collective problem presents itself, and whether it does so in the same way, during the earlier stages of litigation.<sup>190</sup> Also, much of the fiduciary duty litigation over the past twenty years has been in the takeover context, presenting cases that resist tidy classification as involving either straight duty of care or straight duty of loyalty claims. Instead, the intermediate or enhanced scrutiny standards adopted by Delaware courts to deal with takeover cases require judges to review the directors’ actions more carefully than in duty of care cases but more deferentially than in duty of loyalty cases.<sup>191</sup> How would these hybrid cases affect the individual/collective analysis set forth in this Article? I do not seek to answer that question here.

Finally, although this Article works within the confines of fiduciary duty suits, the individual/collective question also may be important in other areas of corporate and securities law. One such area is Section 11 of the Securities Act of 1933, which adopts an approach to director liability resembling the

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188. Smith, *supra* note 79, at 1213 (emphasis added).

189. *Id.* at 1206.

190. The existing law on demand futility and special committee dismissals must be taken into account here and not lightly disturbed. See *Aronson v. Lewis*, 473 A.2d 805, 814 (Del. 1984) (noting that the basis for excusing demand includes creating a reasonable doubt that a majority of the board was disinterested and independent or that the challenged decision was a valid exercise of business judgment); *Zapata Corp. v. Maldonado*, 430 A.2d 779, 786 (Del. 1981) (inquiring into the independence of the special committee).

191. Under the basic test in enhanced scrutiny review, the board must show that it had reasonable grounds for believing a threat to corporate policy existed and that the takeover defenses were a proportionate response to that threat. *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954–55 (Del. 1985).

individual approach discussed in this Article.<sup>192</sup> Another is the availability of D&O insurance coverage in cases of stock option backdating. According to the *Wall Street Journal*:

[I]n the realm of directors and officers insurance, lawyers are examining whether an insurer can argue that misconduct by a single director or executive in granting or dating stock options can justify refusing to honor coverage for all of the other directors and officers who were involved in making the grant even if they didn't participate in the misconduct.<sup>193</sup>

For all of these reasons, the individual/collective question is an important one. So far, courts have been answering this question correctly in fiduciary duty litigation, even if their rationales have been less than forthcoming.

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192. See *supra* note 164.

193. Peter Lattman, *Big Law Firms Find Backdating Probes Good for Business*, WALL ST. J., July 19, 2006, at B1.