

# A Defense of the Corporate Law Duty of Care

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## I. INTRODUCTION

The fiduciary duty of care does not seem to get very much respect. Most people would acknowledge the importance of the duty of loyalty,<sup>1</sup> but the same is not true of the duty of care. Historically, the corporate law duty of care has been underenforced at best, and arguably unenforced entirely. When it seemed that the courts might finally breathe life into the duty, legislatures responded quickly to prevent that from happening. Some scholars do not consider the duty of care to be a fiduciary duty at all, and there are those who would do away with it entirely. It seems that the duty of care does not have many defenders these days.<sup>2</sup>

In this Article, I intend to provide a comprehensive defense of the fiduciary duty of care in corporate law. I hope to show that the duty of care is not simply an ill-fitting appendage to the duty of loyalty, but rather an essential aspect of the singular fiduciary concept that also encompasses the duty of loyalty. Simply put, a fiduciary has the duty to act in the interests of the beneficiary in all relevant respects. Once the breadth of this singular fiduciary concept is properly understood, it is revealed to be much more than any of the individual duties that it comprises. Far from being streamlined or focused, fiduciary law would be impoverished if it were limited to the duty of loyalty. Thus, the duty of care should not be eliminated from the ranks of fiduciary duties.

However, I do not intend to argue for a more robust duty of care. Rather, I will defend the duty of care, as it currently exists in corporate law (more or less)<sup>3</sup>—deliberately and advisedly underenforced, but not entirely unenforced.<sup>4</sup> There are many benefits that flow from the duty of care, but also many costs. A policy of reduced enforcement can significantly mitigate many of those costs, while retaining most of the benefits. In other words, the duty of care works in the corporate context precisely because caution is built into the enforcement equation.

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1. In this paper, I will use the term “duty of loyalty” to refer to *traditional* loyalty, focusing on conflicts of interest and self-dealing. See *infra* note 236 and accompanying text (discussing the difference between “the duty of loyalty (as traditionally defined)” and its newer, broader sense).

2. Of course, there are some exceptions, the most notable of which is Professor Lyman Johnson. He has written extensively on the duty of care. See, e.g., Lyman Johnson, *Rethinking Judicial Review of Director Care*, 24 DEL. J. CORP. L. 787, 789 (1999) [hereinafter Johnson, *Rethinking*]; Lyman Johnson, *The Modest Business Judgment Rule*, 55 BUS. LAW. 625 (1999–2000); Lyman Johnson, *Corporate Officers and the Business Judgment Rule*, 60 BUS. LAW. 439 (2005); Lyman Johnson, *Delaware’s Non-Waivable Duties*, 91 B.U. L. REV. 701 (2011); Lyman Johnson, *Unsettledness in Delaware Corporate Law: Business Judgment Rule, Corporate Purpose*, 38 DEL. J. CORP. L. 405, 412 (2013). See also Stuart R. Cohn, *Demise of the Director’s Duty of Care: Judicial Avoidance of Standards and Sanctions Through the Business Judgment Rule*, 62 TEX. L. REV. 591 (1983); Geoffrey P. Miller, *A Modest Proposal for Fixing Delaware’s Broken Duty of Care*, 2010 COLUM. BUS. L. REV. 319 (2010). While Johnson and others may argue for a more robust duty of care, I do not. See *infra* note 3 and accompanying text.

3. In my opinion, it would be ideal to have a robust business judgment rule without the option for exculpation. Optional exculpation provisions are not necessarily problematic. However, they should be easier to adopt and repeal—perhaps by shareholder-adopted bylaw rather than by charter amendment (which also requires the approval of directors).

4. I use the terms “underenforced” and “underenforcement” deliberately. I do not mean less enforcement than is normatively desirable. Rather, I mean enforcing a lower legal standard than that which is normatively desirable. However, as will be made clear, the enforcement of a lower legal standard is intended to lead to the normatively desirable behavior—consistent with the correct legal standard. See *infra* notes 35–41, 105–111 and accompanying text. See also Julian Velasco, *The Role of Aspiration in Corporate Fiduciary Duties*, 54 WM. & MARY L. REV. 519, 550–51 (2012).

This Article will proceed as follows. Part II will consider various arguments against the duty of care. These arguments can be grouped into several categories: that there really is no such duty because it is unenforced; that the duty is undesirable for practical reasons; that the duty is unnecessary because of other forces; and that the duty of care is not a fiduciary duty. The arguments have varying degrees of merit, and each will be considered in turn. One theme will recur: whatever merit the argument may have when considered against a robust duty of care is severely diminished when considered against the existing, underenforced duty. In other words, most arguments against the duty of care are logically only arguments for reduced enforcement of the duty of care. They do not establish that non-enforcement or elimination of the duty of care would be ideal.

Part III will consider various arguments in favor of the duty of care. I start by showing that the duty of care is a well-established fiduciary duty and then address its deterrence value. Next, I argue that the duty of care is necessary because of the duty of loyalty's shortcomings: first, that it is also underenforced and therefore unable to police fiduciary relationships on its own, and second, that the concept of loyalty is inadequate to capture the essence of the fiduciary principle. Finally, I discuss the expressive value of law: the duty of care is necessary to let fiduciaries know that they have a legal duty to pursue the beneficiaries' interests with skill and diligence (i.e., *carefully*), and not merely to avoid conflicts of interest (i.e., *loyally*).

I close with a discussion of why the issue matters. I explain that the fiduciary principle is necessarily broad and expansive and cannot be boiled down to a few simple rules. I then argue that the urge to simplify the law of fiduciary duties by eliminating the duty of care from its ranks is misguided. Finally, I suggest that, in the long run, the courts will tend to resist the reductionist impulse to simplify at the expense of equity. Thus, it is better to accept the duty of care and deal with it directly than to attempt to eliminate it and invite judicial innovation.

## II. ARGUMENTS AGAINST

This part will consider the case against the duty of care. The main arguments fall into four categories, and each will be considered in turn. Section A will consider the argument that there really is no duty of care because it is unenforced. Section B will consider the argument that the duty of care is undesirable for practical reasons. Section C will consider the argument that the duty of care is unnecessary because of other forces that lead to adequate care. Section D will consider the argument that, whatever it may be, the duty of care is not a fiduciary duty.

### *A. Unenforced*

Perhaps the most obvious argument against the duty of care, at least in corporate law, is that effectively there is no such duty. Empirically, there are very few cases where liability has been premised on a breach of the duty of care. Doctrinally, the business judgment rule shields directors from liability in all but the most extreme cases. Moreover, corporations have the option to shield directors from liability for breaches of the duty of care by including exculpation provisions in their charters. It would seem that there is very little, if any, bite left in the duty of care. If that is the case, then perhaps the duty of care should be

explicitly retired once and for all.<sup>5</sup> These arguments are not without merit, but careful consideration can reveal their limits.

### 1. Empirical Response

The most straightforward argument against the duty of care is that it is meaningless because it is virtually unenforced: there are very few cases in which directors have been held personally liable for monetary damages in cases involving solely a duty of care claim.<sup>6</sup> As Professor Joseph Bishop once put it, “[t]he search for cases in which directors of industrial corporations have been held liable in derivative suits for negligence uncomplicated by self-dealing is a search for a very small number of needles in a very large haystack.”<sup>7</sup> The dearth of cases resulting in liability for breach of the duty of care is undeniably relevant, but may not be as damning as it seems. There are circumstances that put the raw numbers into perspective.

Although the cases are few and far between, they are not non-existent. By comparison, cases leading to director liability based solely on the quality of substantive business decisions are truly rare. Although courts often reserve the right to find liability based upon irrational decisions,<sup>8</sup> they rarely do so in fact. Because of this, waste might be fairly described as more theoretical than real.<sup>9</sup> The same is not quite true of procedural care. A leading treatise identifies about a dozen cases that led to director liability for breach of the duty of care.<sup>10</sup> Admittedly, this is not a very large number, but it is not zero. Moreover, the number must be considered in the context of the corporate legal landscape.

5. See, e.g., Kenneth E. Scott, *Corporation Law and the American Law Institute Corporate Governance Project*, 35 STAN. L. REV. 927, 937 (1983) (“In short, very little if any value would be lost by outright abolition of the legal duty of care and its accompanying threat of a lawsuit.”).

6. See, e.g., Joseph W. Bishop, *Sitting Ducks and Decoy Duck: New Trends in the Identification of Corporate Directors and Officers*, 77 YALE L.J. 1078, 1099–1100 (1968) (noting four examples “based on extensive (although not exhaustive) investigation”); Stuart R. Cohn, *Demise of the Director’s Duty of Care: Judicial Avoidance of Standards and Sanctions Through the Business Judgment Rule*, 62 TEX. L. REV. 591, 591 & n.1 (1983) (finding seven cases). See also 1 DENNIS J. BLOCK ET AL., *THE BUSINESS JUDGMENT RULE: FIDUCIARY DUTIES OF CORPORATE DIRECTORS* 167–73 (1998) (discussing twelve cases).

7. Bishop, *supra* note 6, at 1099.

8. See, e.g., *Brehm v. Eisner*, 746 A.2d 244, 263–64 (Del. 2000); David Rosenberg, *Galactic Stupidity and the Business Judgment Rule*, 32 J. CORP. L. 301, 304 (2007) (“Although few courts or commentators are willing to use the term, substantive due care analysis is in fact alive in Delaware fiduciary law, and has been for at least two decades.”); William T. Quillen, Trans Union, *Business Judgment, and Neutral Principles*, 10 DEL. J. CORP. L. 465, 492 (1985) (“[T]here can be no question that for years the courts have in fact reviewed directors’ business decisions to some extent from a quality of judgment point of view. Businessmen do not like it, but courts do it and are likely to continue to do it because directors are fiduciaries.”). Compare *In re Caremark Int’l, Inc. Deriv. Litig.*, 698 A.2d 959, 967 (Del. Ch. 1996) (“Compliance with a director’s duty of care can never appropriately be judicially determined by reference to the content of the board decision that leads to a corporate loss[.]”) (emphasis in original).

9. See *Gagliardi v. Trifoods Int’l, Inc.*, 683 A.2d 1049, 1051–52 (Del. Ch. 1996) (noting that the theoretical exception for “egregious” decisions has never resulted in a money judgment against a director).

10. See 1 BLOCK ET AL., *supra* note 6, at 167–72. Many of the cases involve financial institutions, such as banks, which may have the need for a heightened duty of care. See generally Christopher M. Bruner, *Conceptions of Corporate Purpose in Post-Crisis Financial Firms*, 36 SEATTLE U. L. REV. 527, 538–40 (2013) (describing cases in which directors were held liable); Patricia A. McCoy, *A Political Economy of the Business Judgment Rule in Banking: Implications for Corporate Law*, 47 CASE W. RES. L. REV. 1, 3 (1996) (describing the curtailing of the business judgment rule in response to lending practices that triggered bank runs). However, not all cases involve financial institutions. Moreover, that fact does not seem especially relevant in some of the cases that do.

The lack of cases can readily be explained by the divergence between standards of conduct and standards of review in corporate law.<sup>11</sup> Standards of conduct are rules addressed to actors, specifying expectations regarding their behavior, while standards of review are rules addressed to courts, specifying how actions are to be judged. In most areas of law, standards of conduct and review converge. For example, in tort law, the standard of conduct is ordinary care, and the standard of review is negligence. The same is not true in corporate law, where standards of conduct and standards of review diverge. This divergence is most evident in the business judgment rule.

Delaware defines the business judgment rule as “a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.”<sup>12</sup> Alternatively, the business judgment rule can be described as a deferential standard of review for duty of care cases.<sup>13</sup> Thus, although the standard of conduct for the duty of care is something like ordinary care, the standard of review is gross negligence rather than mere negligence.<sup>14</sup> Some would characterize the business judgment rule as a policy of non-review,<sup>15</sup> although this characterization seems more appropriate with respect to the substance of business decisions than to the decision-making process.<sup>16</sup>

The next section considers the justification for the business judgment rule. For present purposes, it is sufficient to note that the business judgment rule explains why there are so few cases leading to director liability. Because the standard of review is so deferential, the burden on the plaintiff is quite high. The natural consequence of such deference is that few cases result in liability. Additionally, if it is difficult to recover against directors for breach of the duty of care, then it may not be worthwhile to file many such lawsuits in the first place. Furthermore, any meritorious cases are likely to settle early.<sup>17</sup> Thus, one should not expect to find many cases leading to director liability based on the duty of care.

In fact, the legal landscape is even more complicated. The law might have evolved to

11. See generally Melvin A. Eisenberg, *The Divergence of Standards of Conduct and Standards of Review in Corporate Law*, 62 *FORDHAM L. REV.* 437 (1993). See also Velasco, *supra* note 4, at 546–53 (discussing rationale for the divergence).

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

13. See Julian Velasco, *Structural Bias and the Need for Substantive Review*, 82 *WASH. U. L.Q.* 821, 828–29 (2004) (“It is better understood as either a standard of review or a policy of non-review.”); E. Norman Veasey & Christine T. Di Guglielmo, *What Happened in Delaware Corporate Law and Governance From 1992–2004? A Retrospective on Some Key Developments*, 153 *U. PA. L. REV.* 1399, 1417 (2005) (describing the business judgment rule as a standard of review). See also Stephen M. Bainbridge, *The Business Judgment Rule as Abstention Doctrine*, 57 *VAND. L. REV.* 83, 87 (2004) (“The business judgment rule commonly is understood today as a standard of liability by which courts review the decisions of the board of directors.”).

14. *Aronson*, 473 A.2d at 812 (“[U]nder the business judgment rule director liability is predicated upon concepts of gross negligence.”).

15. See, e.g., Bainbridge, *supra* note 13, at 89–90 (“Alternatively, . . . the business judgment rule can be seen as an abstention doctrine.”); William T. Allen et al., *Function Over Form: A Reassessment of Standards of Review in Delaware Corporation Law*, 56 *BUS. LAW.* 1287, 1297 (2001) (“[The business judgment rule] is an expression of a policy of non-review[.]”); Johnson, *supra* note 2, at 625 (“The business judgment rule . . . is better understood as a . . . policy of non-review[.]”) (emphasis in original).

16. See *infra* notes 26–29, 74–75, 324–327 and accompanying text (describing the difference in review for substance of decision claims as compared to decision-making process claims).

17. See John C. Coffee, Jr., *Litigation and Corporate Governance: An Essay on Steering Between Scylla and Charybdis*, 52 *GEO. WASH. L. REV.* 789, 796 (1984) (“[C]ases are most often resolved by settlement, not judicial decision . . .”).

allow directors less deference and give plaintiffs a better chance of recovering against careless directors. In 1985, in *Smith v. Van Gorkom*,<sup>18</sup> the Delaware Supreme Court held directors personally liable for gross negligence. The case might have been a harbinger of things to come. However, it was not to be. Instead, the Delaware legislature acted quickly to arrest development<sup>19</sup>—as did the legislatures of most states.<sup>20</sup>

Under the laws of most states, director liability for breach of the duty of care either is, or can be, limited or even eliminated altogether. For example, under Section 102(b)(7) of the Delaware General Corporation Law, corporations are permitted to include in their charters an exculpation provision that essentially eliminates directors' exposure to personal liability for breach of the duty of care.<sup>21</sup> Most public corporations quickly adopted such a provision, such that they are now nearly ubiquitous.<sup>22</sup> As a result, it is fair (if not entirely accurate) to say that directors generally cannot be held accountable for breaches of the duty of care. Of course, if recovery of damages is no longer a possibility, then one would expect to see very few lawsuits. Moreover, one could not expect the lawsuits that do arise to lead to the imposition of personal liability on directors.

Thus, the empirical data cannot be said to reflect the nonexistence of a duty of care but rather reflects the legal landscape characterized by a deferential business judgment rule coupled with ubiquitous exculpation provisions. In light of the legal landscape, one could expect more than simply a lack of liability or even a lack of cases. If successful duty of care claims are rare, then one would expect to find cases channeled away from duty of care issues and towards duty of loyalty issues whenever possible.

Fiduciary duties are not necessarily tidy concepts. The duty of care and the duty of loyalty are not polar opposites, and in many cases may overlap.<sup>23</sup> In every case involving a breach of fiduciary duty, the claim is that the directors are not pursuing the interests of the shareholders. Many cases may involve violations of both the duty of care and the duty of loyalty, and sometimes conduct might be characterized alternatively as a breach of either. Thus, plaintiffs may have some leeway in deciding how to frame the case. They may be able to allege breach of the duty of care, of loyalty, or of both. Because of the business judgment rule and exculpation provisions, it is unlikely that they would characterize a case as involving solely the duty of care. More likely, they would at least

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

19. See DEL. CODE ANN. tit. 8, § 102(b)(7) (2011) (authorizing corporations to add provisions to their charters insulating directors from personal liability for breach of the duty of care).

20. See MODEL BUS. CORP. ACT ANN. § 2.02(b)(4) (authorizing corporations to add provisions to their charters insulating directors from personal liability for breach of the duty of care). See also *id.* Statutory Comparison 6, at 2–34 (2011 Rev.) (noting which states have adopted similar provisions).

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

22. See J. Robert Brown, Jr. & Sandeep Gopalan, *Opting Only In: Contractarians, Waiver of Liability Provisions, and the Race to the Bottom*, 42 IND. L. REV. 285, 309–10 (2009) (describing the extent to which companies are opting out of liability for directors); Lawrence A. Hamermesh, *Why I Do Not Teach Van Gorkom*, 34 GA. L. REV. 477, 490 (2000) (citing statistics); Miller, *supra* note 2, at 322 (“All, or virtually all, public Delaware companies have opted out of liability[.]”).

23. See Julian Velasco, *How Many Fiduciary Duties Are There in Corporate Law?*, 83 S. CAL. L. REV. 1231, 1297 (2010) (“[T]he relationship among the various fiduciary duties is . . . complex. Thus, it is inadequate to describe fiduciary duties as lying on a linear continuum.”); *In re Walt Disney Co. Deriv. Litig.*, 907 A.2d 693, 746 n.402 (Del. Ch. 2005) (“Perhaps these categories of care and loyalty, so rigidly defined and categorized in Delaware for many years, are really just different ways of analyzing the same issue.”); Coffee, *supra* note 17, at 792 (noting that the distinction between duty of care and duty of loyalty “is often fuzzy and is not susceptible to a simple either/or test”).

characterize as involving both the duty of care and the duty of loyalty. However, realizing that the chances of prevailing on the duty of care claim are slim, they may not pursue it at all or perhaps only halfheartedly. If so, then even cases that could have been successful under the duty of care might be re-characterized as duty of loyalty cases.

Moreover, judges may be doing something similar. Even cases that have successful claims under both the duty of care and the duty of loyalty may be decided solely under the duty of loyalty.<sup>24</sup> Each court may not want to be the outlier that finds liability under the duty of care when plaintiffs can be made whole under the less controversial duty of loyalty.

Thus, it is possible that there would be many more cases that could have been decided in the plaintiffs' favor based on the duty of care but which were instead decided based on the duty of loyalty. If so, the empirical data is incomplete. Instead of asking how many cases *have* led to director liability based solely on the duty of care, the more important inquiry might be how many cases *could have* led to liability under the duty of care. The number would surely be zero where exculpation provisions are involved, and would still be small when they are not involved, because of the business judgment rule. However, there is reason to believe that the number of cases that *could have* led to liability under the duty of care might be significantly more than the number of cases that have done so.

Thus, the empirical data—the fact that there are very few cases in which directors have been held personally liable for damages solely as a result of a breach of the duty of care—is not a strong basis on which to conclude that there is no duty of care. Given the legal landscape, the data are in line with what should be expected. If we are to conclude that there is no duty of care, it must be based on the legal landscape itself.

## 2. Business Judgment Rule

If the sheer lack of cases leading to director liability does not establish that the lack of a meaningful duty of care, then perhaps the existence of the business judgment rule does. As previously discussed, the business judgment rule can be understood alternatively as a presumption, as a differential standard of review, or as a policy of non-review.<sup>25</sup> However it is described, the business judgment rule lies at the heart of the divergence between standards of conduct and of review and results in deferential judicial review for breach of the duty of care. Claims based on the substance of business decisions are reviewed under the waste test,<sup>26</sup> which is almost insurmountable,<sup>27</sup> while claims based on the decision-

24. Cf. Tamar Frankel, *Corporate Director's 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.”).

25. See *supra* notes 12–16 and accompanying text (describing the business judgment rule).

26. To establish waste claim, plaintiffs must show that consideration for a transaction “is so inadequate in value that no person of ordinary, sound business judgment would deem it worth that which the corporation has paid.” *Grobow v. Perot*, 539 A.2d 180, 189 (Del. 1988) (citations omitted). See also *Lewis v. Vogelstein*, 699 A.2d 327, 336 (Del. Ch. 1997) (discussing the waste standard); *Glazer v. Zapata Corp.*, 658 A.2d 176, 183 (Del. Ch. 1993) (same).

27. See *Zupnick v. Goizueta*, 698 A.2d 384, 387 (Del. Ch. 1997) (“That is ‘an extreme test, very rarely satisfied . . .’”) (quoting *Steiner v. Meyerson* No. 13139, 1995 WL 441999, at \*3 (Del. Ch. July 19, 1995); *Gagliardi v. Trifoods Int'l, Inc.*, 683 A.2d 1049, 1052 (Del. Ch. 1996) (finding that the waste test “has resulted in no awards of money judgment against corporate officers or directors in this jurisdiction”). See also *Allen et al.*, *supra* note 15, at 1318 (“[N]o Delaware case of which we are aware has ever held that a properly ratified transaction constituted waste.”).

making process are reviewed under a gross negligence standard,<sup>28</sup> which is also extremely demanding.<sup>29</sup> The business judgment rule explains why, historically, there have been so few cases leading to director liability for breach of the duty of care. However, given this strong presumption, deferential standard of review, or policy of non-review, perhaps it is fair to say that there really is no meaningful duty of care.

Before we reach that conclusion, we need to consider the reasons behind the business judgment rule. If the idea is that the duty of care need not be enforced strictly because it is not very important, then the business judgment rule supports this conclusion. If, on the other hand, there is some other reasoning, then perhaps the conclusion is inappropriate.

It turns out that the business judgment rule does not exist because the duty of care is undervalued.<sup>30</sup> At least, judges never express any such sentiment. To the contrary, they often opine on the importance of director diligence. And this comports with common sense: of course directors of large corporations should be diligent rather than negligent! Their decisions affect not only the shareholders but also the employees, other businesses, and even the economy as a whole.

The justification for the business judgment rule lies somewhere else completely. Because it is sure to be well known to the reader, I will not go into great detail.<sup>31</sup> Rather, I will point out that the justifications can be categorized into two interrelated groups: the theoretical and the practical. The theoretical foundation of the business judgment rule is trust, and the practical foundation is risk.

Theoretically, the business judgment rule is founded on trust.<sup>32</sup> Judges presume that directors are acting in good faith because they believe that, as a general matter, directors can be trusted. To be sure, when directors have a conflict of interest, they cannot be trusted. In such situations, courts apply the demanding entire fairness test, which requires directors to bear the burden of proof.<sup>33</sup> However, when directors are not conflicted, their interests generally are aligned with those of the shareholders.<sup>34</sup> Thus, courts do not need to police the duty of care very closely. The deferential review of the business judgment rule allows courts to avoid wasting judicial resources on borderline cases that are more likely to be about policy disagreements than actual negligence and focus their attention on only the most egregious cases.

Practically, the business judgment rule is founded on risk. It is an accepted principal

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28. See *supra* note 14 (discussing director liability).

29. See 1 BLOCK ET AL., *supra* note 6, at 134–40 (reviewing a history of the standard through various cases utilizing it).

30. Velasco, *supra* note 4, at 539–40.

31. See generally 1 BLOCK ET AL., *supra* note 6, at 12–18 (describing the rationale for the business judgment rule); Melvin A. Eisenberg, *The Duty of Care of Corporate Officers and Directors*, 51 U. PITT. L. REV. 945, 959–69 (1990); Velasco, *supra* note 13, at 828–34.

32. See Velasco, *supra* note 13, at 834.

33. See generally 1 BLOCK ET AL., *supra* note 6, at 28–32; Velasco, *supra* note 13, at 834–38 (describing the entire fairness test).

34. See Allen et al., *supra* note 15, at 1302 (“[A] board that is not conflicted is motivated to achieve the highest transaction price the market will permit. Because in those circumstances the board’s interests and the interests of the shareholders are aligned, there is no reason for courts to engage in a substantive review of the board’s decision.”); Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110, 117 (1965) (“Generally speaking, managers’ incentives and interests coincide with those of their shareholders in every particular except one: they have no incentive, as managers, to buy management services for the company at the lowest possible price.”).

of business that risk and return are related: you cannot expect to earn a profit without being willing to accept risk, and higher profits generally require a willingness to accept greater risks.<sup>35</sup> Thus, shareholders who invested in the corporation in the hope of making a profit actually want the managers of the corporation to take on appropriate entrepreneurial risks and do not want them to be overly cautious.<sup>36</sup> But managers are naturally more risk averse than shareholders because they have more at stake—i.e., their jobs—than do diversified shareholders.<sup>37</sup> Moreover, if the courts are strictly enforcing a duty of care and holding directors liable for mistakes in judgment, then directors will surely become even more risk averse. Directors would face the entire downside of a business decision—i.e., ruinous personal liability—without benefiting from the upside of their actions—i.e., the profits that go to the corporation and its shareholders.<sup>38</sup> Thus, to encourage directors to take on healthy entrepreneurial risks, directors are afforded deferential review with respect to issues involving the duty of care.

Properly understood, deferential review is a reasonable approach to handling duty of care issues. It may seem counterintuitive, but judicial deference is intended entirely for the benefit of the shareholders. Care is not undervalued; rather, enforcement is simply reduced. This is not so exceptional: laws are not all enforced equally, and no law is enforced perfectly.<sup>39</sup> The business judgment rule reflects a prudential judgment as to the appropriate level of enforcement.<sup>40</sup> The duty of care is enforced lightly, lest the costs exceed the benefits.<sup>41</sup> This decision does not support a move to eliminate the duty of care. Underenforcement is a far cry from non-enforcement.

35. See generally KLEIN ET AL., BUSINESS ORGANIZATION AND FINANCE: LEGAL AND ECONOMIC PRINCIPLES 242–50 (11th ed. 2010).

36. See *Gagliardi v. Trifoods Int'l, Inc.*, 683 A.2d 1049, 1052 (Del. Ch. 1996) (“Shareholders don’t want (or shouldn’t rationally want) directors to be risk averse.”).

37. See Coffee, *supra* note 17, at 802 (“Managers cannot diversify their portfolio . . . because they are essentially overinvested in their own firms.”); Bainbridge, *supra* note 13, at 113 (“[M]anagers obviously cannot diversify their human capital among a number of different firms.”).

38. See William T. Allen et al., *Realigning the Standard of Review of Director Due Care with Delaware Public Policy: A Critique of Van Gorkom and Its Progeny As a Standard of Review Problem*, 96 NW. U. L. REV. 449, 455 (2002) (“[T]he risk of liability, at least in the case of non-management directors, could be highly disproportionate to their incentives for serving as a director. Liability for an imprudent decision could be in the millions, but outside directors rarely receive annual fees commensurate with liability risk of that magnitude.”); Eisenberg, *supra* note 11, at 445 (“[A]t least in the case of non-management directors, liability for the losses caused by an imprudent business decision would often be far out of proportion to the incentives for accepting a directorship.”).

39. See Velasco, *supra* note 4, at 580–85 (discussing underenforcement of legal duties).

40. See Allen et al., *supra* note 38, at 449–50 (“The more lenient standard creates a greater arena of freedom for directors, because the standard is purposefully designed to encourage directors to act without undue inhibition.”); Allen et al., *supra* note 15, at 1296 (“The reasons [for the divergence between standards of conduct and standards of review] are rooted in policy interests.”); Eisenberg, *supra* note 11, at 467–68 (“If directors or officers who violate the standards of reasonableness and fairness sometimes escape liability because of a less demanding standard of review, it is not because they have acted properly, but because utilizing standards of review that were fully congruent with the relevant standards of conduct would impose greater costs than the costs of letting some persons who violated their standards of conduct escape liability.”).

41. See Eisenberg, *supra* note 11, at 467–68 (“[U]tilizing standards of review that [a]re fully congruent with the relevant standards of conduct would impose greater costs than the costs of letting some persons who violated their standards of conduct escape liability.”); Velasco, *supra* note 4, at 552.

### 3. Exculpation

Even if the business judgment rule does not support a decision to eliminate the duty of care, perhaps the authorization of exculpation provisions does.<sup>42</sup> It would seem difficult to characterize the elimination of liability as underenforcement, rather than non-enforcement. Nevertheless, this section will argue that the existence of exculpation provisions does not support the elimination of the duty of care.

Consider the statutory language in Delaware:

(b) In addition to the matters required to be set forth in the certificate of incorporation by subsection (a) of this section, the certificate of incorporation may also contain any or all of the following matters: . . .

(7) A provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, provided that such provision shall not eliminate or limit the liability of a director: (i) For any breach of the director's duty of loyalty to the corporation or its stockholders; (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law; (iii) under § 174 of this title; or (iv) for any transaction from which the director derived an improper personal benefit.<sup>43</sup>

It is noteworthy that the exculpation provision authorized by Delaware law does *not* eliminate the duty of care.<sup>44</sup> It only limits or eliminates the directors' exposure to personal liability for breach of the duty of care. The duty of care itself remains. Although damages against directors are no longer an option, injunctive relief is.<sup>45</sup> This solution reflects the concern discussed earlier that the risk of personal liability would lead directors to excessive risk aversion. Exculpation provisions allow corporations to eliminate that risk, but not the other benefits of the duty of care.

Moreover, only directors can be exculpated under Delaware law. Officers cannot be exculpated, and therefore damages remain an option against many corporate actors.<sup>46</sup> This is potentially significant in light of the Delaware Supreme Court's (surprisingly recent) holding that officers have the same fiduciary duties as directors.<sup>47</sup> Although cases against officers are rare, presumably because it is difficult for shareholders to maintain a derivative

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42. Different states have authorized exculpation provisions in different ways. *See generally* MODEL BUS. CORP. ACT ANN. § 2.02, at 2-34 to -41 (2002) (comparing exculpation provisions across states); 2 WILLIAM E. KNEPPER & DAN A. BAILEY, LIABILITY OF CORPORATE OFFICERS AND DIRECTORS ch. 16, at 16-1 to -24 (7th ed. 2003) (discussing history of exculpation provisions). While in most states it is an opt-in provision, *see id.* at 16-3, in some states it is either an opt-out provision, *see e.g.*, WIS. STAT. § 180.0828(2) (2013); OHIO REV. CODE ANN. § 1701.59(D) (2013), or mandatory, *see e.g.*, IND. CODE § 23-1-35-1(e) (2013); FLA. STAT. § 607.0831 (2013); VA. CODE § 13.1-692.1 (2013). Some states automatically limit the maximum liability of directors. *See e.g.*, VA. CODE § 13.1-692.1 (2013).

43. DEL. CODE ANN. tit. 8, § 102(b)(7) (2014).

44. *See* Eisenberg, *supra* note 31, at 970 ("Although at first glance this statute might seem to enable the virtual elimination of the duty of care, the statute falls short of taking that position[.]").

45. *See* Malpiede v. Townson, 780 A.2d 1075, 1093 (Del. 2001) ("Such a charter provision, when adopted, would not affect injunctive proceedings based on gross negligence."); Arnold v. Soc'y for Sav. Bancorp, Inc., 678 A.2d 533, 542 (Del. 1996) (discussing "the availability of injunctive relief").

46. *See* Gantler v. Stephens, 965 A.2d 695, 709 n.37 (Del. 2009) ("[T]here currently is no statutory provision authorizing comparable exculpation of corporate officers.").

47. *See id.* at 708-09 (holding that "the fiduciary duties of officers are the same as those of directors").

action against officers,<sup>48</sup> the duty of care is technically alive and well as against officers.

In addition, exculpation is optional under Delaware law—and the law of some other states<sup>49</sup>—and requires an affirmative opt-in by the shareholders. Although most corporations have exculpation provisions, not all do. So even if the adoption of an exculpation provision could be considered the elimination of the duty of care, further justification would be required to force this decision upon corporations that have not elected it for themselves.<sup>50</sup> Moreover, as the law stands, corporations can freely choose to remove exculpation provisions from their charters, thereby restoring the duty of care. Again, justification would be required to eliminate this option.

The history of exculpation provisions might be thought to provide additional support for the elimination of the duty of care. Exculpation provisions came about in response to the Delaware Supreme Court’s decision in *Smith v. Van Gorkom*.<sup>51</sup> This legislative response was clearly a rejection of the holding in that case.<sup>52</sup> The exact meaning of the response, however, is not clear. The *Van Gorkom* case “was the first Delaware case to actually hold directors liable for breach of the duty of care in a case in which the board had made a business decision.”<sup>53</sup> In light of that fact, it is easy to suppose that exculpation provisions reflect a rejection of the imposition of damages for breach of the duty of care. However, this reading might be too broad.

The fact that the directors were held liable in the *Van Gorkom* case sent shock waves throughout the corporate world.<sup>54</sup> According to conventional wisdom, insurance companies suddenly refused to provide directors and officers insurance, and many people refused to become directors of public corporations.<sup>55</sup> Even accepting this account,<sup>56</sup> the question remains as to why liability in the *Van Gorkom* case was so shocking.

One possibility is the finding of liability itself. It was commonly believed that directors had never been held liable for breach of the duty of care and perhaps everyone

48. Ordinarily, the board of directors gets to decide whether the corporation should bring a lawsuit on behalf of the company. However, when directors are conflicted, the courts may allow shareholders to bring a derivative action on behalf of the corporation. Although directors may easily be conflicted on the issue of whether a lawsuit should be brought charging themselves with breach of fiduciary duty, they are less likely to be conflicted on the issue of whether a lawsuit should be brought charging officers with breach of fiduciary duty.

49. See, e.g., N.Y. BUS. CORP. LAW § 402(b) (McKinney 2014) (authorizing exculpation provisions); CAL. CORP. CODE § 204(a)(10) (West 2014) (same); MODEL BUS. CORP. ACT § 2.02(b)(4) (same).

50. “Delaware’s legislative policy is to look to the will of the stockholders in these areas.” *Williams v. Geier*, 671 A.2d 1368, 1381 (Del. 1996).

51. *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985). It was not, however, the first Delaware case to hold directors liable for breach of the duty of care. See *infra* note 58 and accompanying text (citing earlier case).

52. See *Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1156, 1166 n.18 (Del. 1995) (“The statute was, in fact, a legislative response to this Court’s liability holding in *Van Gorkom*.”).

53. See, e.g., WILLIAM T. ALLEN ET AL., COMMENTARIES AND CASES ON THE LAW OF BUSINESS ORGANIZATION 234 (4th ed. 2012).

54. See 2 KNEPPER & BAILEY, *supra* note 42, § 16.01, at 16-1 to -2 (7th ed. 2005) (describing legislative response to the *Van Gorkom* decision).

55. See Roberta Romano, *Corporate Governance in the Aftermath of the Insurance Crisis*, 39 EMORY L.J. 1155, 1160 (1990) [hereinafter Romano, *Aftermath*] (“Delaware hoped to ease the insurance crisis by eliminating liability relating to duties typically covered by D&O insurance.”); Roberta Romano, *What Went Wrong With Directors’ and Officers’ Liability Insurance?*, 14 DEL. J. CORP. L. 1, 1–2 (1989) (“There are reports of directors resigning because their firms had lost insurance coverage and of individuals declining invitations to serve on boards in increasing numbers.”).

56. Roberta Romano has suggested that the insurance crisis actually had many causes, and was not simply due to the *Van Gorkom* holding. Romano, *Aftermath*, *supra* note 55, at 1157–59.

thought that they never would be.<sup>57</sup> However, this account seems dubious. In the first place, the Delaware Chancery Court had previously held directors liable for breach of the duty of care.<sup>58</sup> Moreover, the Delaware Supreme Court had held open the possibility of liability.<sup>59</sup> In fact, it had recently established the “gross negligence” standard<sup>60</sup>—which clearly opened up the possibility of liability—without much uproar. It seems unlikely that anyone believed that liability was an impossibility.

More likely, it was the circumstances under which directors were held liable that caused problems in the *Van Gorkom* case. Although the Delaware Supreme Court reaffirmed that the standard of review was gross negligence,<sup>61</sup> they held directors liable under circumstances that many people did not believe amounted to gross negligence,<sup>62</sup> and some thought did not even amount to simple negligence.<sup>63</sup> If the directors’ actions in that case could lead to liability, then everyone’s assumptions concerning the business judgment rule had been wrong—perhaps the business judgment rule had been implicitly overruled. This scenario would more likely lead to outrage than would the mere possibility of liability.<sup>64</sup>

Under this view, exculpation statutes do not reflect the determination that there should be no liability for breach of the duty of care. Instead, such statutes may simply reflect a desire to restore the deference due under the business judgment rule.<sup>65</sup> Liability should be rare, but if the courts can no longer be trusted, then shareholders should be permitted to

57. See, e.g., Christopher M. Bruner, *Is the Corporate Director’s Duty of Care A “Fiduciary” Duty? Does It Matter?*, 48 WAKE FOREST L. REV. 1027, 1039 (2013) (“By the mid-1980s . . . the perception of the marketplace remained that monetary liability could not be imposed upon a director short of disloyalty[.]”).

58. See, e.g., *Lutz v. Boas*, 39 Del. Ch. 585 (1961) (holding independent directors liable for gross negligence in failing to adequately monitor management).

59. See *Graham v. Allis-Chalmers Mfg. Co.*, 188 A.2d 125, 130 (Del. 1963) (“[T]he question of whether a corporate director has become liable for losses to the corporation through neglect of duty is determined by the circumstances.”); *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984) (adopting gross negligence standard); see also Edward Rock & Michael Wachter, *Dangerous Liaisons: Corporate Law, Trust Law, and Interdoctrinal Legal Transplants*, 96 NW. U. L. REV. 651, 658 (2002) (“In three cases in the early 1970s, the court of chancery recognized an enforceable duty of care. In none of these cases was liability imposed on directors.”).

60. *Aronson*, 473 A.2d at 812.

61. *Id.*

62. See, e.g., Allen et al., *supra* note 38, at 458 (“These failures of process may well have constituted ordinary negligence (though some observers dispute even that), but it is difficult to argue that those failures constituted true gross negligence . . .”); Quillen, *supra* note 8, at 498 (“[W]hatever anyone thinks of the directors’ activity in [*Van Gorkom*], most commentators have not viewed the activity as grossly negligent . . .”).

63. See, e.g., Eisenberg, *supra* note 11, at 448 (“[A] gross-negligence standard of review is often associated with Delaware, but in the famous case of *Smith v. Van Gorkom* the Delaware court, although purporting to apply that standard of review, in fact held outside directors to be liable for conduct that many observers believe did not constitute even ordinary negligence.”); Jonathan R. Macey & Geoffrey P. Miller, *Trans Union Reconsidered*, 98 YALE L.J. 127, 129 (1988) (“[T]he facts did not support a finding of negligence, much less gross negligence[.]”); Leo Herzel & Leo Katz, *Smith v. Van Gorkom: The Business of Judging Business Judgment*, 41 BUS. LAW. 1187, 1188 (1986) (“To most (including the authors) the court’s decision [in *Smith v. Van Gorkom*] seems misguided and [the directors’] actions entirely proper.”).

64. Of course, there are those who believe that liability should not be premised upon a breach of the duty of care. See, e.g., Lawrence A. Hamermesh, *A Kindler, Gentler Critique of Van Gorkom and Its Less Celebrated Legacies*, 96 NW. U. L. REV. 595, 595 (2002) (“[L]ike many others, I believe . . . that damages actions premised solely upon an alleged lack of director care are a poor, even destructive, corporate governance tool.”).

65. Cf. Allen et al., *supra* note 38, at 450 (“*Van Gorkom* . . . run[s] counter to Delaware public policies restricting the judicial enforcement of the duty of care to cases where directors have acted in a manner that represents an extreme departure from expected normative behavior[.]”).

eliminate liability altogether rather than suffer the consequences of excessive liability.

Nevertheless, it might be argued that, although the existence of exculpation provisions do not logically support the elimination of the duty of care, the ubiquity of such provisions provides a strong argument that elimination would be a wise course of action. For example, according to Professors Edward Rock and Michael Wachter, shareholders overwhelmingly approved exculpation provisions at a time when shareholding was already concentrated in the hands of institutions, and at the beginning of the rise of institutional investor activism. In the years since, as institutional investors have become increasingly active, there has been no pressure on firms to re-amend their charters to expose their directors to monetary liability for negligent breaches of the duty of care. This is strong evidence that a judicially enforced duty of care is not in shareholders' interests. "At the very least, intelligent and sophisticated shareholders do not think it is in their interests."<sup>66</sup>

Although the argument seems persuasive, it actually has limited value. The widespread adoption of exculpation provisions can speak only to the issue of personal liability for directors, not to other aspects of the duty of care, which are unaffected. Moreover, it is not clear that we should expect what Rock and Wachter suggest. Repeal of exculpation provisions can only be accomplished by charter amendment and thus require director approval. Because this would be extremely difficult to obtain, it is not clear that activists would waste their efforts on it. In other words, the failure to repeal may be a sign of hopelessness rather than acceptance.

Ultimately, neither the existence of exculpation provisions nor their widespread adoption provides strong support for a move to eliminate the duty of care altogether. Like the business judgment rule, exculpation provisions merely reflect the fact that enforcement of the duty of care is a tricky issue. Underenforcement is decidedly better than over-enforcement. But that does not mean that complete elimination is better still.

### *B. Undesirable*

A second line of argument is that the duty of care is actually undesirable as a practical matter. There are three main reasons why this might be so: judicial incompetence, litigation costs, and director risk aversion. This Section will consider each in turn.

#### *1. Judicial Incompetence*

One reason why the duty of care might be considered undesirable is because courts are not particularly good at deciding such cases. Courts are not business experts; they are not qualified to evaluate business decisions.<sup>67</sup> Of course, the problem with the judicial

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66. Rock & Wachter, *supra* note 59, at 659–60.

67. See, e.g., *Brehm v. Eisner*, 746 A.2d 244, 263 (Del. 2000) ("Courts are ill-fitted to attempt to weigh the 'adequacy' of consideration under the waste standard or, *ex post*, to judge appropriate degrees of business risk.") (quoting *Lewis v. Vogelstein*, 699 A.2d 327, 336 (Del. Ch. 1997)); *Cuker v. Mikalauskas*, 692 A.2d 1042, 1046 (Pa. 1997) ("[The business judgment] doctrine prevents courts from becoming enmeshed in complex corporate decision-making, a task they are ill-equipped to perform.") (citation omitted); *Rosenfield v. Metals Selling Corp.*, 643 A.2d 1253, 1262 (Conn. 1994) ("Courts recognize that managers have both better information and better incentives than they . . . . Not only do businessmen know more about business than judges do, but competition . . . provides sufficient punishment for businessmen who commit more than their share of business mistakes.") (citation omitted); *Daniels v. Thomas, Dean & Hoskins, Inc.*, 804 P.2d 359, 367 (Mont. 1990) ("Judges are not business experts and therefore should not substitute their judgment for the judgment of the directors.") (citation omitted); *Auerbach v. Bennett*, 393 N.E.2d 994, 1000 (N.Y. 1979) ("[T]he business judgment doctrine, at least

incompetence argument generally is that courts are not experts in any number of fields into which they are forced to venture.<sup>68</sup> Many of those fields are significantly more complicated than business. For example, courts are not medical experts, either; yet they must, from time to time, sit in judgment over doctors.<sup>69</sup> Thus, the argument proves too much.

However, the argument can be reformulated more modestly. Most of the time, business decisions are likely to involve issues on which reasonable people can disagree.<sup>70</sup> On such matters, court decisions are not likely to add value; they are more likely to amount to second-guessing.<sup>71</sup> Despite this shortcoming, courts may be necessary for duty of loyalty cases because directors cannot be trusted when they have conflicts of interest.<sup>72</sup> However, when directors are not conflicted, judicial incapacity must be taken more seriously.<sup>73</sup>

This is a much stronger argument, but it does not support the elimination of the duty of care. The argument works much better with respect to substance and arguably supports the elimination of the review of the merits of business decisions.<sup>74</sup> It is less strong with

in part, is grounded in the prudent recognition that courts are ill equipped and infrequently called on to evaluate what are and must be essentially business judgments.”); *Dodge v. Ford*, 170 N.W. 668, 684 (Mich. 1919) (“The judges are not business experts.”); Douglas M. Branson, *The Rule That Isn’t a Rule—The Business Judgment Rule*, 36 VAL. U. L. REV. 631, 631–32 (2002) (“In litigation, the [business judgment] rule is a means for conserving judicial resources, thereby permitting courts to avoid being mired down in rehashing decisions that are inherently subjective and ill suited for judges, as opposed to business men and women.”).

68. See Franklin A. Gevurtz, *The Business Judgment Rule: Meaningless Verbiage or Misguided Notion?*, 67 S. CAL. L. REV. 287, 304–21 (1994) (“[S]uch lack of judicial expertise does not distinguish business decisions from medicine and innumerable other fields in which the negligence system holds sway.”) (citations omitted).

69. See Kenneth B. Davis, Jr., *Once More, the Business Judgment Rule*, 2000 WIS. L. REV. 573, 581 (“Can anyone seriously argue that surgeons in the operating room, lawyers in the midst of a heated trial, or accountants up against a closing deadline are not also called upon to make snap judgments in response to circumstances that may be difficult to recreate [sic] in a courtroom years later? Nonetheless, our legal system is quite comfortable relying on the device of litigation to review, invariably with the benefit of hindsight, the quality of these professionals’ performances and to assess damages, often in the millions of dollars, when those performances are found wanting. Why should directors be any different?”).

70. Velasco, *supra* note 13, at 834.

71. See *Joy v. North*, 692 F.2d 880, 886 (2d Cir. 1982) (“[C]ourts recognize that after-the-fact litigation is a most imperfect device to evaluate corporate business decisions. The circumstances surrounding a corporate decision are not easily reconstructed in a courtroom years later, since business imperatives often call for quick decisions, inevitably based on less than perfect information. The entrepreneur’s function is to encounter risks and to confront uncertainty, and a reasoned decision at the time made may seem a wild hunch viewed years later against a background of perfect knowledge.”) See generally Jeffrey J. Rachlinski, *A Positive Psychological Theory of Judging in Hindsight*, 65 U. CHI. L. REV. 571, 619–23 (1998).

72. See Velasco, *supra* note 13, at 834–35 (“If the key insight of the business judgment rule is that directors generally can be trusted, the key insight of the entire fairness test is that this is not always so. . . . [T]here are times when [the directors’ and shareholders’] interests conflict.”).

73. See Edward B. Rock & Michael L. Wachter, *Islands of Conscious Power: Law, Norms, and the Self-Governing Corporation*, 149 U. PA. L. REV. 1619, 1651 (2001) (“On the substance, courts with inferior information will do systematically worse than the internal governance mechanism.”).

74. See *Brehm v. Eisner*, 746 A.2d 244, 264 (Del. 2000) (“Courts do not measure, weigh or quantify directors’ judgments. We do not even decide if they are reasonable in this context. Due care in the decision-making context is *process* due care only.”); *In re Caremark Int’l, Inc. Deriv. Litig.*, 698 A.2d 959, 967 (Del. Ch. 1996) (“[C]ompliance with a director’s duty of care can never appropriately be judicially determined by reference to the *content of the board decision* that leads to a corporate loss[.]”). Many scholars believe that courts should not review the substance of business decisions absent some other breach of fiduciary duty. See, e.g., Bainbridge, *supra* note 13, at 90 (discussing the business judgment rule as a judicial abstention doctrine); Andrew S. Gold, *A Decision Theory Approach to the Business Judgment Rule: Reflections on Disney, Good Faith, and Judicial Uncertainty*, 66 MD. L. REV. 398, 401 (2007); Johnson, *supra* note 15, at 631–32; Veasey & Di Guglielmo, *supra*

respect to the decision-making process.<sup>75</sup> Courts are particularly skilled at evaluating procedural issues, which are less likely (although not entirely unlikely) to be issues about which reasonable minds would differ dramatically. Thus, while it may be fair to say that courts are incompetent to review the substance of business decisions, it is not fair to say that courts are incompetent to review the decision-making process.

To the extent that courts do lack the expertise to review the directors' decision-making processes, this shortcoming is better addressed by deferential review than by eliminating the duty of care. The business judgment rule addresses this concern nicely. Because courts may not be confident that they can determine when directors have been negligent, they only hold directors accountable when they find gross negligence.<sup>76</sup> The deference ensures that, despite judicial incompetence, directors generally will be held accountable only when they deserve to be—*i.e.*, when they actually are negligent. By contrast, the incompetence of judges is not a very good reason to leave directors unaccountable in the most extreme cases.

## 2. *Litigation Costs*

One might reasonably question the value of highly deferential review. After all, if so few cases lead to liability, then perhaps there is little benefit coming from duty of care cases. One can reasonably question whether it is worth the litigation costs incurred by society to obtain that small benefit. Perhaps it would be better, from a cost-benefit perspective, to eliminate the duty of care.<sup>77</sup>

Although this is an empirical question beyond the scope of this Article, there are reasons to believe that a cost-benefit analysis would not support eliminating the duty of care. First of all, the costs associated with the duty of care likely are not very high. Because of the business judgment rule, and all the more because of exculpation provisions, duty of care cases do not create tremendous litigation costs.<sup>78</sup> Pure duty of care cases are rare. More often, a care claim is appended to a loyalty lawsuit, but it is not pursued aggressively, and is easily dismissed. It would be difficult to maintain that duty of care litigation is running amok.

Moreover, the benefit side of the equation may not be as empty as the detractors suggest.<sup>79</sup> Because even a rare finding of liability can be so very consequential,<sup>80</sup> it is reasonable to believe that, in addition to any negative effects, such cases will have a

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note 13, at 1421–24.

75. Many scholars have supported a substance-process distinction under the business judgment rule. *See, e.g.*, S. Samuel Arshat, *The Business Judgment Rule Revisited*, 8 HOFSTRA L. REV. 93, 120 (1979); Eisenberg, *supra* note 31, at 965; Quillen, *supra* note 8, at 500–01.

76. *See* Velasco, *supra* note 4, at 550–52.

77. *See* Scott, *supra* note 5.

78. *See* Coffee, *supra* note 17, at 827 (“[D]ue care litigation has been only a small tail on a much larger dog.”); Velasco, *supra* note 13, at 884–87 (discussing how corporate law cuts off litigation for care cases); *cf.* Edward B. Rock, *Saints and Sinners: How Does Delaware Corporate Law Work?*, 44 UCLA L. REV. 1009, 1094 (1997) (“[I]t is possible that the accepted wisdom that litigation is brought in almost every deal is simply an overstatement.”).

79. *Cf.* Zapata Corp. v. Maldonado, 430 A.2d 779, 788 (Del. 1981) (“[I]f we failed to balance all the interests involved, we would in the name of practicality and judicial economy foreclose a judicial decision on the merits. At this point, we are not convinced that is necessary or desirable.”).

80. For example, the consequences of the *Van Gorkom* case, holding directors liable for a breach of the duty of care, were quite significant. *See supra* notes 51–55 and accompanying text.

positive deterrent effect on directors.<sup>81</sup> In other words, a very few negative judgments can go a long way in keeping directors honest.<sup>82</sup>

Ideally, the effect is twofold. First, it can remind directors that, if they go too far, they may be held liable (unless, of course, there is an exculpation provision in place). Second, it can give directors an indication of at least the outer boundaries of acceptable behavior.<sup>83</sup> For example, when the Delaware Supreme Court in *Brehm v. Eisner*<sup>84</sup> opined on the duty of care and suggested that “[t]his is potentially a very troubling case on the merits” that “pushes the envelope of judicial respect for the business judgment of directors,”<sup>85</sup> directors across the country were put on notice that they were reaching the limits of judicial forbearance. In subsequent opinions in that case, the court explained more fully what directors should have done differently.<sup>86</sup> Even though the defendants were not held liable, wise directors should have learned that they must be more careful in the future.<sup>87</sup> However, if the duty of care were eliminated altogether, the courts would have no opportunity to opine on director care. Directors would have no indication of where the limits were—essentially, there would be none!<sup>88</sup>

To be sure, the courts can make mistakes. *Smith v. Van Gorkom*<sup>89</sup> could be considered the perfect example: directors were held personally liable for conduct that many people

81. See, e.g., Melvin A. Eisenberg, *Corporate Law and Social Norms*, 99 COLUM. L. REV. 1253, 1277 (1999) (describing “the deterrent effect” as among “the most important” and the “most obvious” of “benefits of shareholder suits to shareholders as a class”); Charles M. Elson & Robert B. Thompson, *Van Gorkom’s Legacy: The Limits of Judicially Enforced Constraints and the Promise of Proprietary Incentives*, 96 NW. U. L. REV. 579, 580 (2002) (“The impact of *Van Gorkom* lies not in its holding, which has been eviscerated by subsequent legislative action, but in its refocusing the corporate governance debate on deficiencies in the role of directors and unleashing a richer array of alternative constraints that include markets, contracts, and norms.”); Rock, *supra* note 78, at 1103 (“[E]ven the corporate actor who is immune to the social sanctions of Delaware corporate law will be constrained to some degree by Delaware ‘law.’”).

82. See Velasco, *supra* note 13, at 912 (“[T]he impact of catching a few additional cases of abuse should not be underestimated.”).

83. Cf. Roberta Romano, *The Shareholder Suit: Litigation Without Foundation?*, 7 J.L. ECON. & ORG. 55, 85 (1991) (“[L]egal rules are public goods. All firms benefit from a judicial decision clarifying the scope of permissible conduct. The benefit of clarification is not simply deterrence of future managerial misconduct, but rather . . . identification of a rule around which the parties (managers and shareholders) can transact.”).

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

85. *Id.* at 249.

86. See, e.g., *In re Walt Disney Co. Deriv. Litig.*, 906 A.2d 27, 35 (Del. 2006) (affirming the lower court’s ruling that the directors did not breach their duty of care following a \$130 million severance payout to the former Disney president).

87. See *Brehm*, 746 A.2d at 256 (“Aspirational ideals of good corporate governance practices . . . can usually help directors avoid liability.”); Rock, *supra* note 78, at 1103 (“[T]he ‘thick-skinned’ businessman wants to skate close to the edge . . . . But his lawyer is likely to advise him that such behavior will make it more likely that the deal will be enjoined, or that he will be left unprotected against maneuvers by his opponents.”). I have argued in the past that too much deference under the business judgment rule can have an opposite effect: “Under the business judgment rule, courts are limited in their ability to develop the standard of conduct under the duty of care. Because the standards of review are mere rationality and gross negligence, courts spend far more time justifying shoddy behavior than demanding excellence.” Velasco, *supra* note 13, at 916 (citations omitted). See also Coffee, *supra* note 17, at 798 (“[T]he impact of minimum standards may well be to communicate an unintended message that compliance with the minimum is all that should be expected.”). This is not inconsistent with the current claim. If too much deference can be bad, then, *a fortiori*, zero accountability is worse. For a more complete discussion of the expressive and pedagogical role of law, see *infra* Part III.E.

88. For a discussion of the need for enforceability, see *infra* notes 284–85 and accompanying text.

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

believe was not even negligent, much less grossly negligent.<sup>90</sup> However, the case must be kept in perspective. It was a unique case in Delaware history.<sup>91</sup> Far more common are the cases where many believe that directors got away with gross negligence. Although judicial error is inevitable, it is hard to argue that it is biased against directors in the realm of corporate law.<sup>92</sup>

Moreover, the existence of exculpation provisions should quell any concerns. Corporations can, and generally do, eliminate personal liability of directors for breach of the duty of care. As a result, litigation costs are kept to a minimum.

### 3. *Risk Aversion*

Another reason why a duty of care may be undesirable is because of director risk aversion. As discussed earlier, directors are naturally risk-averse, while shareholders are not—and they do not want directors to be.<sup>93</sup> The potential for liability for breach of the duty of care can only make matters worse.<sup>94</sup> By eliminating the duty of care, perhaps we can eliminate the disincentives that skew director conduct.

Although the foregoing argument is corporate law dogma, it has limited applicability to the issue at hand. The argument is at its strongest when discussing the risk of liability for bad outcomes.<sup>95</sup> If directors had to guarantee that their decisions would lead to good outcomes, there would indeed be a serious problem. However, that is not the case. The core of the business judgment rule shields the substance of business decisions from judicial review,<sup>96</sup> at least in all but the most extreme cases.<sup>97</sup> The duty of care is not concerned with outcomes. Rather, the duty of care looks at director diligence and the decision-making process.<sup>98</sup> It is far more reasonable to hold directors legally accountable for the care they exercise than for the results they generate because the former is in their direct control while the latter is not.

90. See *supra* notes 61–63 and accompanying text.

91. The *Technicolor, Inc.* litigation is another case where the courts found the directors were grossly negligent. However, the courts ultimately concluded that the transaction was entirely fair despite the directors' gross negligence, and directors were not held personally liable. See *Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1156, 1179–80 (Del. 1995).

92. Professor Bainbridge has argued that, “If the business judgment rule is treated as a standard of liability, rather than as an abstention doctrine, [*i.e.*, if there is an enforceable duty of care] judicial intervention readily could become the norm rather than the exception.” Bainbridge, *supra* note 13, at 127. However, as an empirical matter, history has proven this to be a very slight risk. An equally plausible claim could be made to the reverse effect; if there is no enforceable duty of care, then director misconduct could become the norm rather than the exception.

93. See *supra* notes 36–37 and accompanying text (discussing differing risk profiles of directors and shareholders).

94. See *supra* note 38 and accompanying text (discussing impact of potential liability on directors' risk aversion).

95. See *supra* notes 74–75 and accompanying text (discussing relative validity of risk aversion argument with respect to issues of substance and process).

96. See *supra* note 74 and accompanying text.

97. See *Brehm v. Eisner*, 746 A.2d 244, 264 (Del. 1998) (“Irrationality is the outer limit of the business judgment rule.”). See also 1 BLOCK ET AL., *supra* note 6, at 84–90, 93–97 (discussing abuse of discretion and waste standards); Rosenberg, *supra* note 8, at 304 (“It is well settled that the business judgment rule will not allow review of director decision that, in retrospect, are ‘pretty dumb,’ ‘substantially wrong,’ or degrees of wrong extending through ‘stupid’ to ‘egregious’ or ‘irrational’[.]”).

98. See *Brehm*, 746 A.2d at 264 (“Due care in the decisionmaking context is *process* due care only.”).

Nevertheless, the argument against the duty of care does not focus on objective reasonableness, but on actual incentives. The fact remains that liability, if imposed, could be ruinous.<sup>99</sup> Thus, it could be argued that the duty of care, even if otherwise reasonable, distorts directors' incentives to the detriment of shareholders.

However, the fact that the mere possibility of liability can provide a disincentive is not a very strong argument. There is also the possibility of liability for breach of the duty of loyalty and of criminal laws; these, too, can provide unfortunate disincentives at the margins. Sometimes we simply have to accept some unfortunate disincentives to provide appropriate incentives. The question then becomes whether the benefits of the duty of care outweigh the drawbacks.

Of course, the duty of care is significantly different than the duty of loyalty or criminal law in some important respects. For example, criminal law and, to a lesser extent, the duty of loyalty have as their main goal the prohibition of misconduct—*i.e.*, crime and unfair self-dealing. The duty of care, on the other hand, seeks to mandate good behavior—*i.e.*, diligence.<sup>100</sup> It is generally considered more important to prevent misconduct than to require good conduct.<sup>101</sup> Moreover, care is considered by many to be a nebulous concept that lacks bright lines.<sup>102</sup> It is difficult for directors to be sure that they have exercised due care,<sup>103</sup> and it is difficult for the courts to be confident that they have not.<sup>104</sup> Given that all parties involved are prone to make mistakes, it may seem unfair to subject directors to the possibility of ruinous liability.

These are very strong arguments. However, there are ways to deal with them short of eliminating the duty of care. Again, the business judgment rule provides for deferential judicial review.<sup>105</sup> Although the standard of conduct requires directors to avoid negligence, the standard of review provides that they shall only be held liable for gross negligence. This is not because we believe that gross negligence is the theoretically appropriate standard. Rather, it is to allow the parties room for error.<sup>106</sup>

99. See *infra* note 224 and accompanying text.

100. See Arthur B. Laby, *Resolving Conflicts of Duty in Fiduciary Relationships*, 54 AM. U. L. REV. 75, 120 (2004) (“The fiduciary’s duty of care . . . requires affirmative conduct to act in the principal’s interest with respect to the assets or affairs of the principal entrusted to the fiduciary.”).

101. See LON L. FULLER, *THE MORALITY OF LAW* 5–9 (rev. ed. 1969) (distinguishing “morality of duty” from “morality of aspiration”); Laby, *supra* note 100, at 129–33 (discussing “the sentiment that one generally treats harm from failing to act more leniently than harm from committing an act”).

102. See Ehud Kamar, *A Regulatory Competition Theory of Indeterminacy in Corporate Law*, 98 COLUM. L. REV. 1908, 1909–10 (1998) (describing fiduciary duty standards as “indetermina[te],” “vague,” and “open-ended,” which “make[s] prediction of legal outcomes difficult”); Veasey & Di Guglielmo, *supra* note 13, at 1412 (“Because Delaware fiduciary duty law is judge-made, it is ‘far from clear and predictable’ and therefore ‘demonstrates a degree of indeterminacy[.]’”); William F. Kennedy, *The Standard of Responsibility for Directors*, 52 GEO. WASH. L. REV. 624, 632 (1984) (“[N]egligence is not a self-defining concept from which one can deduce a set of particularized expectations as to how directors should behave[.]”).

103. See John C. Coffee, Jr., *Paradigms Lost: The Blurring of the Criminal and Civil Law Models—And What Can Be Done About It*, 101 YALE L.J. 1875, 1879 (1992) (stating that fiduciary duty standards “can never be fully realized nor even defined with specificity in advance”).

104. See Rock & Wachter, *supra* note 59, at 667 (“[J]udges cannot reliably distinguish between negligent and non-negligent behavior.”).

105. *Supra* notes 35–41 and accompanying text.

106. See generally Velasco, *supra* note 4, at 546–53 (discussing “room for error” justification for business judgment rule); Eisenberg, *supra* note 11, at 444, 465 (“[I]t may often be difficult for factfinders to distinguish between bad decisions . . . that turn out badly.”).

Although the gross negligence standard has been criticized extensively,<sup>107</sup> it is not terribly problematic. It was intended to be a far more forgiving standard than ordinary negligence<sup>108</sup> and, for the most part, has proven to be so in corporate law. To be sure, both directors and the courts can make mistakes on the issue of gross negligence. However, because gross negligence is far more forgiving than mere negligence, it is highly unlikely that the courts will find non-negligent behavior to be grossly negligent.<sup>109</sup> If a court erroneously concludes that director behavior was grossly negligent, it is extremely likely that the directors were nevertheless ordinarily negligent—and therefore deserving of liability.<sup>110</sup> Understood in this way, the business judgment rule does not give directors a pass for negligent behavior. It merely enforces a lower standard to ensure that directors will never be held liable for non-negligent behavior. Directors are thus freed from any reasonable concern with liability: as long as they are attempting to be diligent, it is extremely unlikely that they will be held liable, even if they make some mistakes along the way.<sup>111</sup>

At this point, the argument for eliminating the duty of care altogether becomes very weak. It would have to rely on one of two assumptions: either that directors are extremely risk-averse, such that even the business judgment rule is inadequate to alleviate their fears, or that the duty of care is intrinsically harmful because any preoccupation with care on the part of directors will lead to excessive caution.

The first assumption is highly unlikely. Although directors may be risk averse, presumably this preference is strictly rational, not irrational. Directors are unlikely to be exceptionally faint of heart or to jump at shadows.<sup>112</sup> Thus, it does not seem fair to assume that directors are extremely risk-averse.

The second assumption is more interesting. It suggests that the business environment is such that it is often inappropriate for directors to spend any thought on care issues because it is likely to lead to excessive caution. In other words, even conduct that is clearly gross negligence under any standard is sometimes appropriate under the circumstances. Although that is a possibility, the legal rule should be based on typical cases, not the rare exceptional one. Moreover, care is a contextual concept and already should be open to the

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107. See, e.g., W. PROSSER & W. KEETON, PROSSER & KEETON ON TORTS 210–11 (5th ed. 1984) (“The prevailing rule in most situations is that there are no ‘degrees’ of care or negligence, as a matter of law; there are only different amounts of care, as a matter of fact. From this perspective, ‘gross’ negligence is merely the same thing as ordinary negligence, ‘with the addition,’ as Baron Rolfe once put it, ‘of a vituperative epithet.’”) (citations omitted). See also Arshat, *supra* note 75, at 120 n.119 (citing sources).

108. See *Aronson v. Lewis*, 473 A.2d 805, 812 n.6 (Del. 1983) (“[A] long line of Delaware cases holds that director liability is predicated on a standard which is less exacting than simple negligence.”).

109. See Velasco, *supra* note 4, at 551 (“[D]irectors may wrongly be found to have acted with gross negligence. That is likely only when directors were actually negligent, however. It seems highly unlikely that a director who acted with due care will be found to have been grossly negligent.”). But see *supra* notes 61–63 and accompanying text (discussing the *Van Gorkom* case).

110. See Velasco, *supra* note 4, at 550 (“If the legal system were perfect . . . [o]nly directors who were actually negligent . . . would face liability. Such directors should be held liable.”).

111. See Velasco, *supra* note 4, at 551 (“Directors can feel confident that, as long as they try to act with due care, they will not be found liable for breach of the duty of care.”).

112. See Rock, *supra* note 78, at 1100 (“One might suspect . . . ‘that being a successful businessman requires having a very thick skin, even enjoying the reputation of someone who skates close to the edge, even being something of an outlaw.’”) (quoting Letter from Erick Posner). But cf. David A. Skeel, Jr., *Shaming in Corporate Law*, 149 U. PA. L. REV. 1811, 1812 (2001) (“The directors of large U.S. corporations are, in the words of one shareholder activist, ‘the most reputationally sensitive people in the world.’”).

possibility that some circumstances require less process than others.<sup>113</sup> There is no need to eliminate the duty of care because it can accommodate this concern to a large extent. Elimination of the duty of care would go too far: it seems highly unlikely that directors should never (or only rarely) be expected to worry about process.

However, even if these arguments against the duty of care have merit, it is still not enough reason to eliminate the duty of care because of the existence of exculpation provisions.<sup>114</sup> Corporations can, and most do, eliminate personal liability of directors for breach of the duty of care.<sup>115</sup> With the possibility of liability off the table, the argument from risk aversion vanishes completely. It simply cannot support the elimination of the duty of care. To argue otherwise, one would have to maintain that the directors are so risk averse that they would be overly cautious in their business decisions because of the slight possibility of an injunction.<sup>116</sup> At some point, the argument becomes too strained to maintain with a straight face.

### *C. Unnecessary*

A third line of argument is that the duty of care is unnecessary. Even if the duty of care is not undesirable, we do not need it. Other forces, such as other law and markets, are sufficient. If this is so, then perhaps we ought to eliminate the duty of care.

#### *I. Other Law*

Fiduciary duties are not the only laws that regulate director behavior. Modern corporations operate in a world replete with regulation. From general law, including contracts, torts, and criminal law, to corporate, securities, and antitrust law, to agency regulation for certain industries, to quasi-regulation, such as by generally accepted accounting principles, corporations and the directors that manage them are subject to a great number and variety of legal rules. In light of all this, it might seem reasonable to suggest that another layer of regulation through the duty of care is unnecessary.

However, it is unfair to point to the large number of rules and suggest that more are unnecessary if the other rules have little or nothing to do with the concerns addressed by the duty of care. General law, such as contracts, torts, and criminal law, applies to everyone and is barely relevant to the issues at hand. Certain industries, such as banks and other financial institutions, are subject to special regulation, but that cannot obviate the need for a duty of care that applies to all corporations. The same can be said for antitrust laws, which only apply to corporations in certain circumstances. And while corporate law is more extensive than just fiduciary duties, it chooses to regulate managers' behavior primarily by

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113. The standard of conduct under the duty of care is nearly always described contextually. For example, in Delaware, "directors of a corporation in managing the corporate affairs are bound to use that amount of care which ordinarily careful and prudent men would use in similar circumstances." *Graham v. Allis-Chalmers Mfg. Co.*, 188 A.2d 125, 130 (Del. 1963). Under the Model Business Corporation Act, directors must "discharge their duties with the care that a person in a like position would reasonably believe appropriate under similar circumstances." MODEL BUS. CORP. ACT. § 8.30(b) (2005). The circumstances are built into the duty of care analysis.

114. See, e.g., DEL. CODE ANN. tit. 8, § 102(b)(7).

115. See *supra* notes 21–22 and accompanying text (discussing adoption of exculpation provisions).

116. See *supra* note 45 and accompanying text (noting that injunctive relief remains available despite adoption of exculpation provision).

means of fiduciary duties, including the duty of care.

Securities regulation and accounting rules are somewhat different. For the most part, they regulate information acquisition and disclosure rather than the decision-making process that is the concern of the duty of care. However, the decision-making process is intimately involved with information issues. Thus, it is inevitable that securities regulation and accounting rules would have a significant effect on the decision-making process, if only indirectly. Requiring corporations to maintain and disclose detailed information about the company will certainly assist directors in remaining informed about the business. Thus, of all the areas of law, this is the area that is most likely to provide a sufficient alternative to the duty of care.

However, securities regulation and accounting rules do not obviate the need for the duty of care. First, they do not apply to all corporations, but only to public corporations. In addition, they do not regulate all corporate information equally. Rather, they focus on the generation and disclosure of information that the corporation must make public. They do not directly regulate the additional private information that directors need to make effective decisions. Thus, they do not serve the same purpose as the duty of care. Moreover, the availability of information does not ensure that it will be used.<sup>117</sup> Securities regulation makes almost no effort to ensure that directors are doing a good job; its primary concern is that they not mislead the shareholders.<sup>118</sup> The actual performance of their duties is not a concern. Thus, the duty of care remains necessary.

In short, the existence of multiple areas of regulation does not necessarily obviate the need for others that address different concerns. Moreover, the duty of care is not simply another area of regulation. It is a very different kind of regulation—one that is based primarily on standards rather than rules.<sup>119</sup>

In many cases, the law operates primarily on the basis of *ex ante* rules. Laws set forth, with specificity, what can and cannot be done. This allows people to know exactly what the law requires and forbids. Generally, business law is well-suited to straight-forward, *ex ante* rules-based regulation. Businesses can deal with almost any level of regulation, provided they know what the rules are and can plan accordingly. However, sometimes it is difficult or even impossible to specify in advance what must and cannot be done. In such cases, there is a need for alternative forms of regulation.

For example, *ex ante* rules-based regulation is a particularly inadequate way to regulate management's discretion in its pursuit of shareholder interests. Business circumstances are fluid, and steeped in uncertainty. Under such circumstances, it is

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117. It is not fanciful to suggest that directors may not utilize all the information that is generated by the corporation. Unlike officers and employees, the directors work for the corporation on a part-time basis. They have neither the time nor the inclination to review all the information that is available.

118. See *Santa Fe Indus. v. Green*, 430 U.S. 462, 478 (1997) (“[O]nce full and fair disclosure has occurred, the fairness of the terms of the transaction is at most a tangential concern of [federal securities law].”).

119. I do not mean to suggest that the duty of care, or fiduciary duties, is the only source of standards-based regulation of corporations. I only claim that fiduciary duties are based more heavily on standards than most other forms of corporate regulation, and therefore add significant value to the regulatory mix. For a discussion of the difference between rules and standards, see generally REINIER KRAAKMAN ET AL., *THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH* 39–40 & Table 2-1 (2009) (discussing the difference between *ex ante* and *ex post* regulation in the corporate context); Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 *DUKE L.J.* 557 (1993) (offering an economic analysis of the consequences of promulgating legal commands as rules or standards); Pierre Schlag, *Rules and Standards*, 33 *UCLA L. REV.* 379 (1986) (highlighting and explaining the differences between rules and standards).

difficult—perhaps even impossible, and certainly unwise—to specify what directors should and should not be doing. Any specific regulation would be as likely to be harmful in many circumstances as it would be helpful in others. The likely effect would be to squash the entrepreneurial spirit and replace it with a bureaucratic one—a result that the shareholders would want to avoid. Thus, when it comes to fiduciary duties, corporate law makes a dramatic shift towards *ex post*, standards-based regulation.<sup>120</sup>

As opposed to rules, standards give only a general indication of what is required. The law tells corporate officers and directors that they must pursue the interests of the corporation and its shareholders, but otherwise grants them considerable discretion to decide upon a course of action. They are then subject to an after-the-fact review of the propriety of their actions.<sup>121</sup> As a result, management is free to respond to changing circumstances as it deems appropriate—without being restricted by detailed rules. However, directors and officers can be held accountable if they abuse their discretion. As long as directors' actions are reviewed with the appropriate level of deference, shareholders get the benefit of both entrepreneurialism and accountability. This is something that *ex ante*, rule-based regulation cannot easily provide.

One could argue that fiduciary duties, and other *ex post*, standards-based regulation, are inherently unfair in that they do not provide adequate notice to directors of the type of conduct that could lead to liability.<sup>122</sup> However, if we were to eliminate fiduciary duties, we would need to replace them with laws that serve the same purpose. It would be extremely difficult, perhaps impossible, to develop *ex ante* rules that would serve that role adequately. Any such laws would have a stifling effect on the corporation's entrepreneurialism and competitiveness.

Of course, there is a third alternative. The duty of care could be eliminated and not replaced with any other law, leaving the decision-making process entirely unregulated. However, this is not a very viable option. Modern democratic society seems to demand that those with great power, including corporate management, be held accountable.<sup>123</sup> The current state of affairs between shareholder rights activists and corporate directors suggests that many shareholders, at least, are not interested in reducing director accountability any further. The fact is that directors cannot be trusted enough to be left completely

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120. See Allen et al., *supra* note 15, at 1289 (“[T]he second key function of the law of corporations . . . [is] the *ex post* judicial review of the actions of corporate officers and directors, measured by fiduciary principles.”); Jeffrey N. Gordon, *The Mandatory Structure of Corporate Law*, 89 COLUM. L. REV. 1549, 1593 (1989) (“Fiduciary duties provide a set of standards to restrain insiders in exercising their discretionary power over the corporation and its shareholders in contingencies not specifically foreseeable and thus over which the parties could not contract. Accordingly, parties do not know the decision rule for matters governed by fiduciary duties at the time that they enter into the corporate contract.”); Mark J. Roe, *Delaware's Politics*, 118 HARV. L. REV. 2491, 2527 (2005) (“Delaware's primary lawmaking mode is judicial interpretation of fiduciary duties, punctuated by occasional legislation . . . [I]t acts via *ex post* judicial review of corporate actions, focusing on the fairness and efficacy of shareholder-board relationships.”). The concepts of standards and *ex post* regulation are distinct, although closely related.

121. See Gordon, *supra* note 120, at 1596 (“[T]he content of fiduciary duties is appropriately supplied by the criterion of fairness *ex post*[.]”).

122. See Kaplow, *supra* note 119, at 607–08 (describing concerns that standards may fail to provide clear notice on what is required or forbidden); Schlag, *supra* note 119, at 385 (distinguishing the pros and cons of rules and standards).

123. See Frankel, *supra* note 24, at 717 (“Those who manage and control other peoples' money must be judicially accountable. It is, therefore, unlikely that the courts will relinquish their authority over directors' fiduciary duties.”).

unaccountable, even if only with respect to the duty of care. This is not because directors are less trustworthy than others. To the contrary, they are presumably as trustworthy—but only as trustworthy—as others. There is no basis on which to assume that directors as a class are people of extraordinary virtue.

Thus, the existence of other law does not provide adequate justification for eliminating the duty of care. Fiduciary duties generally, and the duty of care in particular, serve a special role in policing corporate management. The alternative would be an undesirable increase in legal regulation.

## 2. Market Forces

Another argument that the duty of care may be unnecessary is that market forces may be adequate to ensure director diligence. “It is now widely recognized that a variety of markets—product, employment, capital, and corporate control—constrain inefficient management performance . . . .”<sup>124</sup> Moreover, market forces are often considered to be more effective regarding care issues than loyalty issues.<sup>125</sup> “Where incentive mechanisms created by one part of the corporate structure—the various markets in which the corporation and its managers function—constrain managerial discretion to perform inefficiently, one would not expect a different part of that structure to provide redundant controls.”<sup>126</sup> Thus, perhaps there is no need for a duty of care.

Although there can be no doubt that market forces can have a disciplining effect upon directors’ conduct, the question remains whether the effect is sufficient to justify the elimination of the duty of care. “It is undoubtedly the case that both liability rules and market forces are important in constraining the behavior of corporate officials.”<sup>127</sup> In fact,

124. Ronald J. Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819, 824 (1981). See also Henry N. Butler & Larry E. Ribstein, *Opting Out of Fiduciary Duties: A Response to the Anti-Contractarians*, 65 WASH. L. REV. 1, 18–32 (1999) (discussing various market forces that constrain management conduct); Daniel R. Fischel, *The Corporate Governance Movement*, 35 VAND. L. REV. 1259, 1288 (1982) (“The discipline exerted by product and capital markets, the market for managerial services, and the market for corporate control severely limits the divergence of interest between managers and investors.”); Jonathan R. Macey, *Private Trusts for the Provision of Private Goods*, 37 EMORY L.J. 295, 303–06, 315 (1988) (arguing that “[c]ompetition in capital markets, product markets, and the market for corporate control all induce managers and directors of public corporations to act in ways consonant with shareholder welfare”); Robert B. Thompson, *The Law’s Limits on Contracts in a Corporation*, 15 J. CORP. L. 377, 380–82 (1990) (describing various market forces that constrain management); Elson & Thompson, *supra* note 81, at 580–82 (“Product markets indirectly constrain managers’ decisions, as do the capital market, the market for managerial services, and the market for corporate control.”); Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251, 262–73 (1977) (discussing constraint on management control created by market forces including stock price).

125. See, e.g., Thompson, *supra* note 124, at 408 (“As compared to the law’s relative less-effectiveness in responding to loyalty concerns, the markets arguably are more likely to affect duty of care violations.”).

126. Gilson, *supra* note 124, at 839. See also Scott, *supra* note 5, at 936 (“Given this array of monitoring mechanisms and incentives, the duty of care lawsuit (or its threat) seem of minor importance.”); Daniel R. Fischel & Michael Bradley, *The Role of Liability Rules and the Derivative Suit in Corporate Law: A Theoretical and Empirical Analysis*, 71 CORNELL L. REV. 261, 274–76 (1986) (discussing alternatives to liability rules for assuring contractual performance).

127. Michael Bradley & Cindy A. Schipani, *The Relevance of the Duty of Care Standard in Corporate Governance*, 75 IOWA L. REV. 1, 5 (1989). See also Bainbridge, *supra* note 13, at 110 (“It would be naive to assume that markets fully constrain director behavior.”); Rock, *supra* note 78, at 1011 (“But on examination, none of these checks, with the exception of competitive product markets, when they exist, seems to provide a very robust check on managers. Each seems to help a little some of the time, and only occasionally seems to help

some scholars doubt how effective market forces can be. As Professor Melvin Eisenberg succinctly argued,

The discipline of product markets is limited by the fact that a corporation may earn profits and survive for a long period of time despite bad management, just as it may incur losses or even fail despite good management. The discipline of the capital market is blunted by the ability of corporations with large cash flows to meet their capital needs for a long period of time through internal and even external financing, although profits are lower than good management would produce. The discipline of the market for corporate control is limited by a number of elements, including the high transaction costs of takeover bids, the necessity to offer a premium well in excess of market price, the requirements of relevant statutes, the defensive techniques available, the incentives to take over efficiently run as well as inefficiently run companies, and the time lag often experienced by potential acquirors in ascertaining lack of managerial efficiency. Direct review by the body of shareholders is seldom an efficacious instrument of accountability in publicly held corporations because of the disparate and shifting nature of the shareholder body and the complexity of modern management issues. Oversight of managers by more senior managers is undoubtedly very effective as to middle and lower management, but cannot serve to hold accountable the corporation's top management, particularly the chief executive officer.<sup>128</sup>

No one would claim that market forces are sufficiently robust to obviate the need for all law. "In fact, markets may increase pressure on corporate management to breach fiduciary duties."<sup>129</sup> Thus, the question becomes how much law, and what kinds of laws, are optimal? The proper balance between market forces and legal forces has been debated at length, and there is no logically correct answer. Nevertheless, there are reasons to believe that market forces are not sufficient to justify the elimination of the duty of care.

First, recent history strongly suggests that market forces are incapable of preventing corporate misconduct. Whether one considers the securities fraud that occurred in firms such as Enron and Worldcom at the turn of the century, or the widespread imprudence that led to the more recent financial collapse, neither market forces nor legal forces—nor even both operating together—seem to be doing an adequate job. The idea that corporate actors will regulate themselves out of self-interest is no longer as highly regarded as it used to be.<sup>130</sup> Even if it could be said that market forces do a better job in the long run, it is

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a lot.”)

128. Melvin Aron Eisenberg, *New Modes of Discourse in the Corporate Law Literature*, 52 GEO. WASH. L. REV. 582, 583–84 (1985).

129. Tamar Frankel, *Fiduciary Duties as Default Rules*, 74 OR. L. REV. 1209, 1255 (1995). See Helen A. Garten, *Whatever Happened to Market Discipline of Banks*, 1991 ANN. SURV. AM. L. 749 (discussing the dark side of “market discipline”).

130. See Bloomberg Surveillance, Bloomberg Radio Interview with Arthur Levitt (Dec. 12, 2011), available at [http://media.bloomberg.com/bb/avfile/vKxulW\\_if.w8.mp3](http://media.bloomberg.com/bb/avfile/vKxulW_if.w8.mp3) (“We learned that our oversight mechanism is deeply flawed . . . that oversight by self-regulation is up to *severe* question. Does self-regulation work? Watching MF Global, you’d have to say: no, it doesn’t work.”); Alan Greenspan, Chairman of the Federal Reserve, Testimony to Committee of Government Oversight and Reform (Oct. 23, 2008), available at <http://web.ntpu.edu.tw/~guan/courses/Greenspan's%20testimony.pdf> (“[T]hose of us who have looked to the self-interest of lending institutions to protect shareholder’s equity (myself especially) are in a state of shocked disbelief.”); James Surowiecki, *Bankers Gone Wild*, THE NEW YORKER (July 30, 2012),

undeniable that additional forces could be helpful to prevent serious dislocations in the short run.

Second, just as market forces cannot be expected to eliminate the need for law altogether, they should not be expected to eliminate the need for particular laws. As discussed earlier, different laws address different concerns.<sup>131</sup> Unless market forces can eliminate a concern, they cannot eliminate the need for a law that addresses that concern. At most, market forces and other laws can only reduce the need for enforcement of certain laws. However, this makes the duty of care a particularly poor candidate for reform, because it is already being enforced at a very low level.

A third reason to believe that market forces do not limit the need for duty of care is the fact that people obey the law for reasons other than enforcement.<sup>132</sup> In other words, even if market forces are sufficiently disciplinary to eliminate the need for the enforcement of the duty of care, it would not necessarily eliminate the benefits of having a duty of care. This point will be taken up in greater detail later in this Article.<sup>133</sup> For now, it is worth noting that, if people obey the law at least in part simply because it is the law and not solely in order to avoid punishment, then there may be a significant benefit to having a duty of care and requiring directors to be diligent.

Finally, market forces are less likely to operate on directors than officers. Officers have their lives and careers invested in the company. If market forces destroy the company, it is the officers who will suffer—not the directors. Independent directors are only part-timers, whose lives and careers are more heavily invested in other companies.<sup>134</sup> Thus, market forces are considerably weaker with respect to directors. And yet, directors play a very important role in corporate governance—one that is very different than that played by officers. We want and need directors to be diligent. Thus, it is unlikely that market forces eliminate the need for the duty of care.

In short, whether the disciplinary effect of market forces can eliminate the need for particular laws is an empirical question that is not within the scope of this paper. However, market forces cannot eliminate the need for all law. There are good reasons to believe that they do not eliminate the need for a duty of care.

#### *D. Not Fiduciary*

The fourth line of argument would be that, even if there must be a duty of care, it need not be considered a fiduciary duty. It might better be considered a contractual duty or a tort duty, but it is not truly fiduciary in nature. This Section will defend the corporate law duty of care against such arguments.

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[www.newyorker.com/magazine/2012/07/30/bankers-gone-wild](http://www.newyorker.com/magazine/2012/07/30/bankers-gone-wild) (“[I]f recent history has taught us anything, it’s that self-regulation doesn’t work in finance, and that worries about reputation are a weak deterrent to corporate malfeasance.”).

131. See *supra* Part II.C.1.

132. See generally TOM TYLER, *WHY PEOPLE OBEY THE LAW* (2006) (arguing that people obey the law for various reasons); LYNN STOUT, *CULTIVATING CONSCIENCE: HOW GOOD LAWS MAKE GOOD PEOPLE* (2011) (same).

133. See *infra* Part III.E (discussing the expressive and pedagogical value of law).

134. See Roberta S. Karmel, *Is the Independent Director Model Broken?*, 37 SEATTLE U. L. REV. 775, 789 (2014) (“Independent directors are part-time participants in a corporation’s affairs. By definition, they are outsiders. However intelligent, hardworking, or strong minded they may be, they do not have the time or the mandate to challenge management’s judgments except as to a discrete number of issues.”).

### 1. Contractual Duty

It is possible to conceive of the duty of care as a mere contractual duty.<sup>135</sup> In brief, the argument runs as follows: Because the director's relationship to the corporation is consensual, the duties of that relationship should be governed by agreement. However, parties to a long-term relationship cannot efficiently specify all the terms and obligations of the relationship. To facilitate transactions, the law provides implied terms to fill in the gaps. These implied terms are merely default rules and should always give way to the explicit agreement of the parties. Thus, the parties to the relationship should be permitted to choose how rigorous the duty of care should be. If they are able to do this, then the duty of care is contractual in nature.

Scholars have considered the merits of the argument extensively, on both a descriptive and normative level.<sup>136</sup> Inevitably, the debate draws on various issues considered throughout this entire Article.<sup>137</sup> In this Section, I will limit the discussion to the question of whether the contractarian argument, as such, provides support for the elimination of the duty of care in particular.

One noteworthy aspect of the contractarian argument is that its logic applies equally well to the duty of loyalty.<sup>138</sup> Simply put, it is actually an argument that all fiduciary duties are contractual terms rather than law. Most scholars seem to find the argument more persuasive with respect to the duty of care than the duty of loyalty.<sup>139</sup> However, this is generally not an evaluation of the merits of the contractarian argument itself; rather, it tends to be an assessment on the relative need for enforcement. The contractarian argument, in its pure form, applies to both duties equally and denies any special legal significance to fiduciary duties.<sup>140</sup> Thus, the argument proves too much, at least for present purposes. It is ultimately irrelevant on the issue of whether the duty of care should be considered as much a fiduciary duty as the duty of loyalty.

Are fiduciary duties legal or merely contractual in nature? At a high enough level of abstraction, the difference between the two perspectives can seem to fade into

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135. See, e.g., Frank H. Easterbrook & Daniel R. Fischel, *Contract and Fiduciary Duty*, 36 J.L. & ECON. 425, 427 (1993) ("Fiduciary duties are not special duties; they have no moral footing; they are the same sort of obligations, derived and enforced in the same way, as other contractual undertakings."); Larry E. Ribstein, *Are Partners Fiduciaries?*, 2005 U. ILL. L. REV. 209, 215 (2005) ("Fiduciary duties are a type of contract term[.]").

136. See, e.g., Frankel, *supra* note 129 (arguing against the contractarian definition of fiduciary duties); Deborah A. DeMott, *Beyond Metaphor: An Analysis of Fiduciary Obligation*, 1988 DUKE L.J. 879 (arguing it is erroneous to equate fiduciary obligations with contract law); Scott FitzGibbon, *Fiduciary Relationships Are Not Contracts*, 82 MARQ. L. REV. 303 (1999) (identifying differences between fiduciary relationships and contractual relationships); Reza Dibadj, *The Misguided Transformation of Loyalty into Contract*, 41 TULSA L. REV. 451 (2006) (arguing the duty of loyalty is an important feature of fiduciary relationships, and framing it as a contractual relationship would weaken important protections). See also John C. Coffee, Jr., *The Mandatory/Enabling Balance in Corporate Law: An Essay on the Judicial Role*, 89 COLUM. L. REV. 1618 (1989) (explaining shortcomings of the contractarian view).

137. In particular, proponents of the contractarian argument tend to rely on the disciplinary effect of market forces to argue against the duty of care. See *supra* Part II.C.2.

138. Easterbrook & Fischel, *supra* note 135, at 426 ("[T]he duty of loyalty is a response to the impossibility of writing contracts completely specifying the parties' obligations.").

139. See *supra* notes 74–75, 95–97 and accompanying text.

140. If the contractarian argument is correct, then both the duty of care and the duty of loyalty are merely default rules. By contrast, if the argument is wrong, then both are legal duties. However, considering fiduciary duties to be law does not require that they be entirely mandatory, because they could be waivable duties, or simply repealed.

insignificance. On the one hand, fiduciary law is perfectly capable of accommodating non-mandatory obligations. Fiduciary law scholars readily acknowledge that, under certain circumstances, shareholders should be permitted to waive at least some fiduciary duties.<sup>141</sup> Generally, they simply want to put in place sufficient safeguards to ensure that the waiver is informed and voluntary<sup>142</sup> (although in certain cases or extreme circumstances, they may want to reserve the right to prevent or disregard a waiver).<sup>143</sup> On the other hand, contractarian theory can and must accommodate mandatory terms.<sup>144</sup> For example, all contracts are subject to laws of general applicability that prohibit or compel certain behavior. In addition, contract law itself has many mandatory rules. Ultimately, any law could be understood as a mandatory contractual term, and fiduciary duties could be counted among them.

I do not mean to suggest that the difference between law and contract is irrelevant. To the contrary, it can be very important when dealing with particular issues.<sup>145</sup> My point is simply that either concept can be subsumed by the other when considered at a sufficiently general level. Therefore, the extent to which fiduciary duties generally (and the duty of care in particular) should be mandatory is a policy question that depends upon other factors. The label “contract” (or “law” for that matter) does not have talismanic significance.

The corporate law duty of care already does, to a large extent, operate contractually. In states such as Delaware, a corporation can choose whether to amend its charter to eliminate directors’ personal liability for breach of the duty of care—but not of the duty of loyalty.<sup>146</sup> To be fair, such an option is not perfectly contractual: it does not empower the parties to determine the exact level of care they would like, but only allows for a limited set of options. There does not seem to be flexibility to impose a higher standard, such as ordinary negligence,<sup>147</sup> nor a lower standard, such as the elimination of injunctive relief.<sup>148</sup>

141. See, e.g., Frankel, *supra* note 129, at 1231 (“There are good reasons for viewing fiduciary rules as default rules and for enforcing the parties’ bargain around them.”); Coffee, *supra* note 136, at 1690 (“[T]here is a middle ground: courts can tolerate and monitor some departures in this area, much as they have done in other forms of contracting. The relevant task for the future then should be to define the area of tolerable departures, rather than to prolong the holy war over opting out.”).

142. See, e.g., Frankel, *supra* note 129, at 1230 (“Even if fiduciaries may make such requests [i.e., for a waiver of a duty], the nature of the relationship requires that the parties follow a unique procedure when they bargain around these duties[.]”); Coffee, *supra* note 136, at 1624 (“[D]epartures from the default rules of fiduciary duty must be sufficiently specific and bounded to permit the departure to be accurately priced.”).

143. See, e.g., Frankel, *supra* note 129, at 1214 (“[C]ircumstances exist where fiduciary duties are not waivable for reasons such as doubts about the quality of the entrustors’ consent (especially when given by public entrustors such as shareholders), and the need to preserve institutions in society that are based on trust.”); Coffee, *supra* note 136, at 1624 (“Beyond [a] mandatory minimum, the parties are free to contract around those fiduciary norms that require selflessness, but not around those that seek to prevent fraud and opportunism.”).

144. See, e.g., Easterbrook & Fischel, *supra* note 135, at 429 (“[L]egislatures often create nonwaivable rules. . . . [M]any of these rules in corporate and securities laws, even seemingly rigid ones, are best understood as implicit contractual terms.”); Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416, 1428 (1989) (“Even terms that are invariant—such as the requirement that the board of directors act only by a majority of a quorum—are contractual to the extent that they produce offsetting voluntary arrangements.”).

145. I agree with Tamar Frankel, who argues that “in terms of both psychological fact and organization of the law, a name is important and reclassification can be treacherous.” Frankel, *supra* note 129, at 1211.

146. See DEL. CODE ANN. tit. 8, § 102(b)(7) (2014).

147. It is not entirely clear whether shareholders could impose a higher standard of care. However, there does not seem to be any real demand for a higher standard.

148. See *supra* note 43 and accompanying text.

However, there is not much of a public outcry for either option. On the bottom-line question of whether or not there should be personal liability for breach, the corporate law duty of care is largely contractual (while the duty of loyalty is not). However, the contractarian argument logically cannot support the elimination of the duty of care—or of any duty. Contractarians should be as opposed to the elimination of the duty of care as they are to its imposition.

Ultimately, the contractual argument for the elimination of the duty of care in particular is not very strong. The contractarian issue with the duty of care has nothing to do with the substance of the duty, and everything to do with its mandatory imposition by law. As such, it is really an argument against fiduciary duties generally, not against the duty of care specifically.

## 2. Tort Duty

It is also possible to consider the duty of care to be a tort duty.<sup>149</sup> After all, care and negligence are the hallmarks of tort law: everyone has the duty (of a reasonable person under the circumstances) not to create unreasonable risks of harm to others.<sup>150</sup> Moreover, the Restatement (Second) of Torts manages to fit breach of fiduciary duty within its scope.<sup>151</sup> Perhaps the corporate law duty of care is not a fiduciary duty at all but merely a tort law duty.

The main problem with this argument is that the effect would not be to eliminate the corporate law duty of care, or even weaken it, but rather to strengthen it. That is because in tort law, unlike corporate law, there is no divergence between standards of conduct and standards of review.<sup>152</sup> The standard of conduct is ordinary care, and the standard of review

149. See, e.g., Robert J. Rhee, *The Tort Foundation of Duty of Care and Business Judgment*, 88 NOTRE DAME L. REV. 1139, 1139 (2012) (arguing that “[f]iduciary duty in corporation law rests on a tort foundation”); Deborah A. DeMott, *Breach of Fiduciary Duty: On Justifiable Expectations of Loyalty and Their Consequences*, 48 ARIZ. L. REV. 925, 927–34 (2006) (discussing breach of fiduciary duty as a tort action); William A. Gregory, *The Fiduciary Duty of Care: A Perversion of Words*, 38 AKRON L. REV. 181, 188–89 (2005) (“A duty of care claim is always a tort action and is always based on negligence. A duty of care claim can never be a breach of fiduciary duty.”). But see Marcel Kahan & Edward B. Rock, *When the Government Is the Controlling Shareholder*, 89 TEX. L. REV. 1293, 1327 (2011) (“As a conceptual matter, it is also pretty clear that breaches of fiduciary duties are not torts, at least not in the common law use of that term, although they may be ‘civil wrongs.’”); Charles Hansen, *The ALI Corporate Governance Project: Of the Duty of Due Care and the Business Judgment Rule, a Commentary*, 41 BUS. LAW. 1237, 1241 (1986) (“A careful reading of the cases illustrates the substantial difference between applying the due care test in tort law and the standard actually employed by the courts in reaching decisions under corporate law.”).

150. See DAN B. DOBBS ET AL., *THE LAW OF TORTS* § 127, at 398 (2d ed. 2011) (“The duty owed by all people generally—the standard of care—is the duty to exercise the care that would be exercised by a reasonable and prudent person under the same or similar circumstances to avoid or minimize risks of harm to others.”).

151. See RESTATEMENT (SECOND) OF TORTS § 874 (1979) (“One standing in a fiduciary relation with another is subject to liability to the other for harm resulting from a breach of duty imposed by the relation.”). Two points are worth making regarding the Restatement. First, it does not purport to provide a comprehensive theory of fiduciary duty. It merely claims that “the action [for breach of fiduciary duty] may properly be regarded as in tort for damages, being an equitable tort even when the action is in the traditional scope of equitable jurisdiction.” *Id.* at Reporter’s Note. The Restatement even acknowledges that “Some fiduciary relations, such as those of . . . director and corporation are the subject of a considerable group of substantive rules . . . governing the relationship.” *Id.* Second, the Restatement’s claim is not limited to the duty of care but extends to all of fiduciary duties. Thus, it does not provide support for the claim that the duty of care is a mere tort duty while the duty of loyalty remains a fiduciary duty.

152. See, e.g., Eisenberg, *supra* note 11, at 437 (“In many or most areas of law, these two kinds of standards

is negligence—the two are opposite sides of the same coin. If this principle were to be applied to the corporate law duty of care, then the standard of review would be raised from gross negligence<sup>153</sup> to ordinary negligence. In other words, a tort law foundation would more likely lead to the evisceration of the business judgment rule than the elimination of the duty of care.

Professor Robert Rhee has argued that “the liability scheme of corporate boards under the doctrines of fiduciary duty and the business judgment rule can be understood through the analytics of torts.”<sup>154</sup> He claims that tort law principles should lead to essentially the same liability scheme as is currently enjoyed by directors because various tort law doctrines would be contextually sensitive to the needs of corporate law. Rhee does not argue that the corporate law duty of care *is* a tort duty; he only argues that it *could be*.<sup>155</sup> His analysis, however, represents—at most—an account of how tort law could be massaged to reach those results. It seems unlikely that the law actually would develop in that way.

Contextual sensitivity might very well lead tort law to an interpretation of negligence that, in the corporate law context, is more deferential than usual. However, corporate law currently provides for (almost) no review of the substance of business decisions, and only limited review of the decision-making process under a gross negligence standard.<sup>156</sup> It strains credulity to believe that tort law would ever get anywhere near that level of deference through a logical application of existing principles. The probable end result would be that directors would be held to a much stricter standard of care than they currently are.

Of course, courts could reposition the duty of care in tort law and simply adopt the deference of the business judgment rule as well. By this point, however, one has to wonder what the purpose would be. The corporate law duty of care should be considered a tort law duty rather than a fiduciary duty only if general principles of tort law provide a more useful framework for its application than do general principles of fiduciary law. They do not. Forcing the issue is possible, but unnecessary, and likely to be counterproductive in the long run.

Another reason why tort law is an unlikely home for the corporate law duty of care is because the two have divergent goals. Tort law, to a large extent, focuses on the compensation of injured parties.<sup>157</sup> The corporate law duty of care does not. To some extent, the duty of care may allow for compensation to flow to shareholders, but only incidentally. The goal of the corporate law duty of care, like all other fiduciary duties, is to protect shareholders from abuse at the hands of managers.<sup>158</sup> Compensation is merely one possible means to achieve this goal, and it does not play a very large role in corporate law. Both the business judgment rule and exculpation provisions severely limit the availability

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tend to be conflated.”); Rhee, *supra* note 149, at 1153 (“In other fields of law such as tort law, the standards of conduct and review conflate to a single standard for the purpose of judicial review.”); Velasco, *supra* note 4, at 521 (“In many areas of law, the two types of standards coincide. For example, in tort law, the standard of conduct is ordinary care, and the standard of review is negligence, which is generally defined as the lack of ordinary care.”).

153. See *supra* note 14 and accompanying text.

154. Rhee, *supra* note 149, at 1142.

155. See *id.* (“To be clear, I do not argue that a breach of fiduciary duty is a tort[.]”).

156. See *supra* notes 26–29 and accompanying text (discussing the business judgment rule).

157. See DOBBS ET AL., *supra* note 150, at § 1 (“Tort law is primarily intended to redress legally recognized harms by rendering a money judgment against the wrongdoer.”).

158. See *infra* notes 171–172 and accompanying text.

of damages for breaches of the duty of care, demonstrating that compensation is a secondary concern, at best, in the corporate law context. Thus, tort law and the corporate law duty of care simply do not have enough in common.<sup>159</sup>

Although the corporate law duty of care could be considered a tort law duty, it should not be. The fit simply isn't there. As we will see, the duty of care fits very nicely within the framework of fiduciary law and theory.

### 3. *Distinctiveness*

Another argument that the duty of care is not a fiduciary duty is that care is not distinctively fiduciary.<sup>160</sup> If care is not distinctively fiduciary, then perhaps it ought not be lumped together with the duty of loyalty, which clearly is distinctively fiduciary. This section will respond to that argument and insist that the corporate law duty of care ought to be considered a fiduciary duty because it is inherently fiduciary in nature.

#### *a. Distinctively Fiduciary?*

It seems difficult to argue that the duty of care is distinctively fiduciary. This is because the duty of care also exists in other areas of law, such as tort law and criminal law. By contrast, the duty of loyalty does not. Loyalty is unique to fiduciary and quasi-fiduciary relations. To argue that the duty of care is distinctively fiduciary, one would have to establish that there is something distinctive about the fiduciary duty of care as compared to other duties of care.

The ideal argument would be that the fiduciary duty of care demands more than other duties of care. Fiduciary relations are special relations of trust that demand utmost good faith from fiduciaries. One might reasonably expect a heightened duty of care. However, one would be disappointed. It is true that “[s]ome courts have articulated the standard to be that of ordinarily prudent persons acting under similar circumstances in the conduct of their own affairs.”<sup>161</sup> Arguably, this is not ordinary care.<sup>162</sup> It is more than what would be

159. Although both tort law and the corporate law duty of care may share the secondary goal of deterrence, that is not a sufficient foundation upon which to build. Almost all law has deterrence as a goal.

160. See, e.g., D. Gordon Smith, *The Critical Resource Theory of Fiduciary Duty*, 55 VAND. L. REV. 1399, 1406–07, 1409 (2002) (“In short, the duty of care is ‘not distinctively fiduciary.’”); DeMott, *supra* note 136, at 915 (“That duty [of care], however, is not distinctively fiduciary . . . .”); MATTHEW CONAGLEN, FIDUCIARY LOYALTY 35–39 (2010) (“The duty of care is not peculiar to fiduciaries and so ‘is not to be equated with or termed a ‘fiduciary’ duty.’”).

161. Bradley & Schipani, *supra* note 127, at 18 & n.105. See also *Alaska Plastics, Inc. v. Coppock*, 621 P.2d 270, 278 (Alaska 1980) (“No proof was presented that the alleged acts were unreasonable in the sense that they would not have been taken by ‘an ordinarily prudent man . . . in the management of his own affairs of like magnitude and importance.’”); *Weidner v. Engelhart*, 176 N.W.2d 509, 518 (N.D. 1970) (“The better rule appears to be that a director is bound to exercise, in the performance of the functions of his position, such care as a prudent man should exercise in like circumstances and charged with a like duty, which care is usually, but not necessarily, that which such a person would show in the conduct of his own affairs of a similar kind.”); *Horn Silver Min. Co. v. Ryan*, 44 N.W. 56, 56 (Minn. 1889) (“The measure of care and diligence required of directors is generally held to be such as a prudent man exercises in his own affairs.”); *Besseliu v. Brown*, 97 S.E. 743, 744 (N.C. 1919) (“[T]he directors and managing officers of a corporation . . . are expected and required to give . . . the care and attention that a prudent man should exercise in like circumstances and charged with a like duty, usually the care that he shows in the conduct of his own affairs of a similar kind”).

162. See, e.g., William L. Cary & Sam Harris, *Standards of Conduct Under Common Law, Present Day Statutes and the Model Act*, 27 BUS. LAW. 61, 63 (1972) (discussing Pennsylvania’s history of using such

expected of a simple agent; it requires directors to act as if their own fortunes were at stake. Given the rational assumption that people care more about their own fortunes than those of others, this could be considered a very high standard. In fact, it would seem to parallel the duty of loyalty in that it requires a form of selflessness. Arguably, it is the highest standard of care that could be required of anyone. Thus, it would be distinctively fiduciary.

Unfortunately for that thesis, most states do not articulate their duty of care in that way. Delaware, for example, articulates the duty of care in a way that seems less demanding: it requires that directors “use that amount of care which ordinarily careful and prudent men would use in similar circumstances.”<sup>163</sup> Similarly, the Model Business Corporation Act requires the directors to act “with the care an ordinarily prudent person in a like position would exercise under similar circumstances.”<sup>164</sup> Thus, it is difficult to defend the claim that the corporate law duty of care creates a heightened duty.

Ironically, the argument becomes significantly stronger when reversed. The corporate law duty of care can be said to be distinctively fiduciary not because it is a heightened duty but because it is underenforced. As previously discussed, corporate law is characterized by a divergence between standards of conduct and standards of review, while most other areas of law are not. If the duty of care were not a fiduciary duty, a negligence standard would be enforced; however, only a gross negligence standard is enforced. This makes the corporate law duty of care distinctive.

This argument may seem counterintuitive, but it makes sense. It is because the duty of care is a fiduciary duty that corporate law permits the duty of care to be underenforced. The divergence between standards of conduct and standards of review is based upon fiduciary considerations.<sup>165</sup> First, directors are trusted to act in the shareholders’ interests when they are not conflicted.<sup>166</sup> Second, minimal enforcement is instrumentally desirable because it allows directors to pursue the interests of the shareholders without fear of personal liability.<sup>167</sup> Without these deeply and distinctively fiduciary considerations, the divergence would be difficult to justify. Thus, it is fair to say that the duty of care is distinctively fiduciary because it is underenforced.

Two other arguments concerning the distinctiveness of the corporate law duty of care can be raised, and they are more straightforward and less controversial. The first is that the corporate law duty of care necessarily requires affirmative action while the tort and criminal law duties typically do not. Tort law and criminal law may require actors to be careful if they choose to act, but generally they do not require people to act in the first place.<sup>168</sup> Except under special circumstance, a person will not commit a tort or crime by

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terminology).

163. *Graham v. Allis-Chalmers Mfg. Co.*, 188 A.2d 125, 130 (Del. 1963). *See generally* 1 EDWARD P. WELCH ET AL., *FOLK ON THE DELAWARE GENERAL CORPORATION LAW* § 141.02[A][1], at 4-27 to -28 (6th ed. 2014) (explaining the duty of care).

164. MODEL BUS. CORP. ACT § 8.30(a)(3).

165. *See* Joseph Hinsey, *Business Judgment and the American Law Institute’s Corporate Governance Project: The Rule, The Doctrine, The Reality*, 52 GEO. WASH. L. REV. 609, 610 (1984) (“Although not often described as such, the business judgment rule basically is an equitable concept.”); Velasco, *supra* note 4, at 546–53 (“The divergence is a powerful tool that allows directors to pursue the interests of the corporation and its shareholders aggressively.”).

166. *See supra* notes 32–34 and accompanying text.

167. *See supra* notes 36–38 and accompanying text.

168. *See* DOBBS ET AL., *supra* note 150, at § 405 (“Absent special relationships or particular circumstances or actions, a defendant is not liable in tort for a pure failure to act for the plaintiff’s benefit.”); 1 WAYNE LAFAVE,

staying home and relaxing. However, the corporate law duty of care affirmatively requires action on the part of fiduciaries. Staying home and doing nothing *is* a breach of the corporate law duty of care. This makes the duty distinctively fiduciary.

A second argument about the distinctiveness of the corporate law duty of care can be made based on the remedies available. In other contexts, the duty of care is a legal duty, and the remedy is limited to compensation in the form of damages. In corporate law, however, the duty of care is an equitable duty. As such, it is open to equitable relief.<sup>169</sup> Thus, it is distinctively fiduciary.

An equitable remedy is not only available, but actually reasonable in the corporate law context—possibly even superior to a legal remedy. In the face of corporate negligence (whether gross negligence or otherwise), an award of damages is often impractical.<sup>170</sup> An injunction against the transaction that was wrongly approved, however, often would make perfect sense. Thus, the corporate law duty of care is more naturally suited to equitable remedies than legal remedies. As such, it is distinctively fiduciary.

### *b. Inherently Fiduciary*

A more fundamental consideration is that there is no reason to believe that the duty of care should have to be distinctively fiduciary in order to be considered a fiduciary duty. Distinctiveness is not generally a requirement for proper categorization. The duty of care may not be distinctively fiduciary, but neither is it distinctively tort or criminal in nature. Care may very well be a universal duty that is not distinctively anything. The lack of distinctiveness does not mean that care is not truly fiduciary, anymore than it means that it is not truly tort or criminal in nature. Distinctiveness is irrelevant. The appropriate question to ask is whether the duty of care is *inherently* fiduciary in nature. As long as it is inherently fiduciary in nature, it is appropriate for consideration alongside any other fiduciary duties, including the duty of loyalty.

The duty of care is inherently fiduciary in nature. Fiduciary relationships are special relationships of trust. The basic principle of fiduciary law is that fiduciaries are required to act solely in the interests of the beneficiary. “[T]he *raison d’être* of fiduciary duties . . . is the protection of the beneficiary from abuse at the hands of the fiduciary”<sup>171</sup>—with abuse meaning any failure by the fiduciary to pursue the interests of the beneficiary.<sup>172</sup> The duty of loyalty does this by preventing directors from acting with a conflict of interest. Thus, directors must pursue the interests of the corporation and its shareholders *loyally*. The duty of care does this by requiring the directors to act with diligence and by preventing them from acting negligently. Thus, directors must pursue the interest of the corporation and its shareholders *carefully*.<sup>173</sup> Although there are differences between loyalty and care, both

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SUBST. CRIM. L. § 6.2 (2d ed. 2003) (“Generally one has no legal duty to aid another person in peril, even when that aid can be rendered without danger or inconvenience to himself.”).

169. See *supra* note 45 and accompanying text (citing sources).

170. See *infra* note 224 and accompanying text (discussing impracticability of damages awards for breach of the duty of care in public corporations).

171. See Julian Velasco, *Fiduciary Duties and Fiduciary Outs*, 21 GEO. MASON L. REV. 157, 159 (2013).

172. Cf. Paul Miller, *The Fiduciary Relationship*, in PHILOSOPHICAL FOUNDATIONS OF FIDUCIARY LAW 63, 75 (Andrew Gold & Paul B. Miller eds., 2014) (“[F]iduciary duties ensure that fiduciary powers are exercised in a manner consistent with the beneficiary’s exclusive claim relative to them”). As I use the term, “abuse” includes acts of omission (e.g., gross negligence) as well as acts of commission (e.g., unfair self-dealing).

173. See Velasco, *supra* note 23, at 1301.

are inherently fiduciary in nature because both are geared towards ensuring that the directors act in the interest of the corporation and its shareholders. Their fundamental purpose is the same; they merely address different issues leading towards the same goal. Thus, they are both properly considered fiduciary duties.<sup>174</sup>

*c. Conflation*

In a recent article, Professor Christopher Bruner has argued that considering the duty of care to be a fiduciary duty is not “inevitable,” but rather “a choice,”<sup>175</sup> and that “styling care a ‘fiduciary’ duty has in fact impacted the evolution of Delaware’s [law] in ways that are not uniformly positive.”<sup>176</sup> According to him, “[c]onflation of these differing circumstances and problems [*i.e.*, care and loyalty] as ‘fiduciary duties’ (plural) or as twin reflections of a ‘fiduciary’ concept (singular) has resulted in a tendency toward overenforcement of the corporate director’s duty of care . . . [and] threatens to facilitate the erosion of the corporate director’s duty of loyalty[.]”<sup>177</sup> Thus, even if the duty of care could be considered a fiduciary duty, perhaps it should not.

Bruner’s argument may be criticized in a number of respects. In the first place, there has been no meaningful “tendency toward over enforcement of the director’s duty of care.”<sup>178</sup> Bruner sees this tendency by describing the development of the duty of care as follows:

[T]he evolution of Delaware’s convoluted framework for evaluating disinterested board conduct—involv[es] an articulation of a duty of care, which was effectively negated by the business judgment rule, revived by the ‘gross negligence’ standard for overcoming the business judgment rule, then negated again by statutory exception, yet potentially revived again by statutory exceptions to exculpation . . . .<sup>179</sup>

The exception to exculpation to which he refers is the “good faith” exception, which “led to a long and tortured debate over the scope of the ‘good faith’ concept,” and which “was not laid to rest until 2006, when *Stone v. Ritter* . . . [adopted] the exacting *Caremark* standard[.]”<sup>180</sup> It is not surprising that Bruner would claim that the duty of care “has, since the 1980s, continually grown by accretion, piling complexity upon complexity.”<sup>181</sup> The back and forth development that he observes can only be “described as vacillation.”<sup>182</sup>

However, his is not the only possible account of the development of the duty of care. A simpler account would be that the duty of care has always been underenforced, with the

174. Cf. Miller, *supra* note 172, at 75 (“[F]iduciary duties ensure that fiduciary powers are exercised in a manner consistent with the beneficiary’s exclusive claim relative to them.”).

175. Bruner, *supra* note 57, at 1038.

176. *Id.* at 1029.

177. *Id.*

178. *Id.* As discussed in Part II.A, enforcement of the duty of care historically has been very limited. It is difficult to characterize this as over enforcement—unless, perhaps, one believes that no enforcement is appropriate. In any event, I take Bruner to be suggesting that the duty of care provides a “periodic[] threat[]” of overenforcement. *Id.* at 1029. I reject this characterization in the text that follows.

179. Bruner, *supra* note 57, at 1028.

180. *Id.* at 1031.

181. *Id.*

182. *Id.* at 1032.

exception of one major case that was quickly repudiated by legislation.<sup>183</sup> Under this account, there is neither complexity nor vacillation. More importantly, there is no “tendency toward over enforcement of the corporate director’s duty of care.”<sup>184</sup> There is only one case that was wrongly decided.<sup>185</sup> Such a track record could compare favorably with just about any legal doctrine.

Notably, Bruner’s account of the development of the duty of care includes the development of the “‘good faith’ concept.” This inclusion materially adds to the complexity he observes. However, the inclusion is misguided because the duty of good faith is not the duty of care.<sup>186</sup> The duty of good faith has alternatively been described as one of triads of fiduciary duty<sup>187</sup> and as a subset of the duty of loyalty,<sup>188</sup> but generally not as part of the duty of care.<sup>189</sup> Contrary to Bruner’s account, the duty of care has remained remarkably consistent over time—consistently underenforced.

In addition, it is unfair to put any blame for “the erosion of the corporate director’s duty of loyalty . . .”<sup>190</sup> on the duty of care. That there has been erosion is undeniable. It is evident not only “in noncorporate settings,” as Bruner acknowledges,<sup>191</sup> but in corporate law as well. As Professor Harold Marsh demonstrated long ago, the duty of loyalty has been suffering erosion for well over a century.<sup>192</sup> This long predates the duty of care developments of the 1980s that Bruner criticizes. It also predates “the ascendance of the ‘law and economics’ movement” that concerns Bruner.<sup>193</sup> For better or for worse, the erosion of the duty of loyalty simply seems to be a trend in business law.<sup>194</sup> Bruner does little to demonstrate that the duty of care is to blame, or that it has “fuel[ed] the contractarian argument.”<sup>195</sup> In fact, given the underlying commitments of the contractarian view, it seems difficult to maintain that the duty of loyalty could have escaped its notice if only there were no duty of care.

Bruner goes on to attribute the Delaware Supreme Court’s opinion in the *Cede & Co. v. Technicolor* case<sup>196</sup> to the conflation of the duty of care with the duty of loyalty. As Bruner describes that opinion,

the *Cede* court fully subsumed the duties of care and loyalty within the BJR,

183. See *supra* note 51–52 and accompanying text (discussing the *Van Gorkom* case).

184. Bruner, *supra* note 57, at 1029.

185. Of course, there may be other cases that were wrongly decided. However, none were as notorious, or significant, as the *Van Gorkom* case. See *supra* note 91.

186. Bruner is on to something here. As I will argue, it is possible to view the duty of good faith developments as a revival of the duty of care. See *infra* Part IV.C.

187. See *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 361 (Del. 1993) (describing the triads of fiduciary duty as “good faith, loyalty [and] due care”).

188. See *Stone ex. rel. AmSouth Bancorporation v. Ritter*, 911 A.2d 362, 369–70 (Del. 2006) (describing the requirement to act in good faith as a subsidiary element of the duty of loyalty).

189. But see *infra* notes 338–341 and accompanying text (arguing that the *Caremark* case was actually a duty of care case).

190. Bruner, *supra* note 57, at 1029.

191. *Id.*

192. See Harold Marsh, Jr., *Are Directors Trustees?*, 22 BUS. LAW. 35 (1966) (surveying the history and breakdown of the duty of loyalty).

193. Bruner, *supra* note 57, at 1048.

194. For one possible explanation for why this may have occurred, see Rock & Wachter, *supra* note 59, at 668–71.

195. Bruner, *supra* note 57, at 1029.

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

depicting the BJR itself as the primary embodiment of the rigors of “fiduciary” status, with care and loyalty alike relegated to secondary status as mere reflections of the BJR. The court lumped together “good faith, loyalty [and] due care” as means of overcoming the BJR, clearly conceptualizing these duties as expressions of a fundamental and singular fiduciary concept embodied more holistically by the BJR itself.<sup>197</sup>

The *Cede* case has been widely criticized along these lines.<sup>198</sup> Bruner is correct that the *Cede* case was a huge mistake. However, it is important to note that the fault does not lie at the foot of the duty of care. The problem was that the court was being too creative for its own good. The court forced fiduciary duties into the business judgment rule, when the business judgment rule might better be considered a mere standard of review.<sup>199</sup> The court also applied the entire fairness test to all breaches of fiduciary duty, when the test was clearly developed for, and only works well in, duty of loyalty cases.<sup>200</sup> In doing all of this, the court was creating an entirely new model for the enforcement of fiduciary duties, even though there was no need to do so.

Bruner argues that none of this would have been possible “had care not been conceptualized [‘as a ‘fiduciary’ duty’].”<sup>201</sup> However, the same could be said for the duty of loyalty: *Cede* would not have been possible had the court dispensed with fiduciary duties altogether, as contractarians might prefer. The relevant question is not one of “but for” causation, but rather of proximate causation: is either the duty of care or the duty of loyalty to blame for these developments? The answer is no on both fronts. The *Cede* approach does not logically flow from either concept. Nor does it flow from the multiplicity of fiduciary duties: the traditional model of fiduciary duties had applied the business judgment rule to duty of care issues and the entire fairness test to duty of loyalty issues.<sup>202</sup> The *Cede* approach was a novel development, and it was a mistake. It is similar to the mistake that the Delaware Supreme Court made in *Stone v. Ritter*,<sup>203</sup> where it demoted the duty of good faith and made it a subset of the duty of loyalty, even though, as I have argued elsewhere, the two have almost nothing to do with each other.<sup>204</sup> That the court may make mistakes while theorizing about the nature of a law is unfortunate, but not a good reason to eliminate the law.

In any event, the holding of *Cede* may not be as bad, as a practical matter, as it appears. In other work, I have argued that it was a mistake without much consequence.<sup>205</sup> Even under the *Cede* framework, the business judgment rule tends to protect duty of care cases,

197. Bruner, *supra* note 57, at 1040 (citations omitted).

198. See, e.g., Johnson, *Rethinking*, *supra* note 2, at 802–03; Allen et al., *supra* note 15, at 1302–03; Velasco, *supra* note 23, at 1305–14.

199. See *supra* notes 13–14 and accompanying text (describing the business judgment rule as a standard of review).

200. See, e.g., Allen et al., *supra* note 15, at 1302–03 (noting that the court offered no explanation for why duty of care claims should be subjected to the same standard of review that applies to duty of loyalty claims); Stephen M. Bainbridge et al., *The Convergence of Good Faith and Oversight*, 55 UCLA L. REV. 559, 585 (2008).

201. Bruner, *supra* note 57, at 1043. See also *id.* at 1042.

202. See Velasco, *supra* note 23, at 1306–07.

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

204. See Velasco, *supra* note 23, at 1252; see also Bainbridge et al., *supra* note 200, at 604 (“[W]hile the Delaware Supreme Court [in *Stone*] seemingly set out to solve some doctrinal puzzles, in doing so it made things worse in many respects.”).

205. See Velasco, *supra* note 23, at 1307.

and the entire fairness test tends to be used to evaluate duty of loyalty cases. Perhaps the most significant aspect of the case was its ultimate resolution: directors were not held liable despite gross negligence because the transaction was nevertheless entirely fair.<sup>206</sup> The effect of the holding was to erode the duty of care *and* the duty of loyalty.

Thus, there is no reason to believe that the decision to consider the duty of care to be a fiduciary duty has caused any harm to the development of the law of fiduciary duties. Despite Bruner's claims, there has been no tendency to overenforce the duty of care, and the erosion of the duty of loyalty has been a trend that predates the modern duty of care. Although there have been a few bad cases here and there, this is unavoidable. However, there has been nothing that would warrant any demotion of the duty of care.

### III. ARGUMENTS IN FAVOR

The fact that the courts recognize a fiduciary duty of care in corporate law is beyond question. Whether they should continue to do so, however, is a normative question that is not beyond dispute. The previous part considered arguments against the duty of care. It concluded that the various arguments provide good reasons not to enforce the duty of care very strictly, but they do not go so far as to establish that the duty of care should be entirely unenforceable, much less eliminated altogether. This Part will consider arguments in favor of the duty of care.

This Part will begin with the straightforward arguments that the duty of care is well-established in corporate law, and that it can have a deterrent effect on director misconduct. It will then argue that the duty of care is necessary because of two major shortcomings in the duty of loyalty. First, the duty of loyalty is itself underenforced, and therefore cannot adequately police fiduciary relationships on its own. Second, the concept of loyalty is inadequate to capture the essence of the fiduciary relation. Finally, this Part will argue that the duty of care serves an important expressive function of telling directors what the law demands of them. This function is undermined, however, if there is not at least a possibility of enforcement.

#### A. Pedigree

One argument in favor of the duty of care is that it is well-established in corporate law. Admittedly, this argument is of limited value. The fact that something is—and even that it long has been—does not establish that it ought to be, or should not be reconsidered. Nevertheless, if this is how corporate law has developed, and there is no urgent reason to make a change,<sup>207</sup> then some might consider the duty of care's pedigree to be an argument for leaving well enough alone.

Although it is clear that the courts do recognize a duty of care in corporate law, one might question how well established the duty really is. As evidence, a skeptic might cite the work of Henry Ridgely Horsey,<sup>208</sup> the Delaware Supreme Court Justice who famously authored perhaps the most significant duty of care case of all time, *Smith v. Van Gorkom*.<sup>209</sup>

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206. *Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1156, 1179 (Del. 1995).

207. See *infra* notes 305–06 and accompanying text.

208. Henry Ridgely Horsey, *The Duty of Care Component of the Delaware Business Judgment Rule*, 19 DEL. J. CORP. L. 971 (1994).

209. *Smith v. Van Gorkon*, 488 A.2d 858 (Del. 1985).

Disappointed by his research,<sup>210</sup> he concluded that “no Delaware court decision espouses the existence of a director’s fiduciary duty to act in an informed manner and with the care of a prudent man until the decision of our separately constituted supreme court in 1963 in *Graham v. Allis-Chalmers Manufacturing Co.*”<sup>211</sup> Thus, it could be argued, the duty of care is of fairly recent origin and does not deserve too much respect and deference.

Horsey’s claim, however reluctantly made, must be evaluated critically. First, it should be noted that this would make the duty of care over 50 years old now—no longer as young as it was when Horsey wrote. Moreover, its age should be put into context: Delaware did not enact its first general incorporation law until 1875,<sup>212</sup> and did not obtain the position of prominence until after New Jersey’s misstep in 1913.<sup>213</sup> Thus, the duty of care has been clearly established for a significant portion of the life of Delaware corporate law. Furthermore, the claim is simply wrong. In 1961, for example, the Delaware Court of Chancery held non-affiliated directors liable for their gross negligence in the case of *Lutz v. Boas*.<sup>214</sup>

In his research, Horsey was looking for the duty of care *in haec verbae*.<sup>215</sup> However, the duty of care may not always be referred to by name. That is likely why he overlooked the *Lutz* case; the opinion never used the terms “duty of care”—or even “care” or “business judgment.” Instead, it spoke of gross negligence and various failings. Nevertheless, it is a duty of care case.

Likewise, this insistence upon particular formulations causes Horsey, and others, to downplay the significance of other cases. Horsey even quotes the following passage from the 1926 case of *Bodell v. General Gas & Electric Corp.*,<sup>216</sup> but downplays its significance:

It is not always necessary for [the directors] to reap a personal profit or gain a personal advantage in order for their actions in performance of their quasi trust to be successfully questioned. Trustees owe not alone the duty to refrain from profiting themselves at the expense of their beneficiaries. They owe the duty of saving their beneficiaries from loss.<sup>217</sup>

This is a fairly clear, albeit not explicit, statement that directors owe not only a duty of loyalty, but also a duty of care. Similar statements can be found in early Delaware cases, such as *Guth v. Loft*.<sup>218</sup> That these cases did not lead to liability for breach of the duty of

210. See Horsey, *supra* note 208, at 981 (“My findings on this aspect of Delaware corporate decisional law were . . . disappointing[.]”).

211. *Id.* at 982–83.

212. See Andrew G.T. Moore II, *A Brief History of the General Corporation Law of the State of Delaware and the Amendment Process*, in 1 R. FRANKLIN BALOTTI & JESSE A. FINKELSTEIN, *THE DELAWARE LAW OF CORPORATIONS & BUSINESS ORGANIZATIONS*, H-1 at H-3 (3d ed. 1999 Supp.); Samuel Arsht, *A History of Delaware Corporation Law*, 1 DEL. J. CORP. L. 1, 4 (1976); William E. Kirk, III, *A Case Study in Legislative Opportunism: How Delaware Used the Federal-State System to Attain Corporate Pre-Eminence*, 10 J. CORP. L. 233, 250 (1984).

213. See Moore, *supra* note 212, at H-8; Kirk, *supra* note 212, at 257–58.

214. *Lutz v. Boas*, 171 A.2d 381, 395 (Del. Ch. 1961). The case may not be the model duty of care case because it involves both a financial institutional and some loyalty issues. However, non-affiliated directors were held liable for their gross negligence.

215. See Horsey, *supra* note 208, at 981.

216. *Bodell v. Gen. Gas & Elec. Corp.*, 132 A. 442 (Del. Ch. 1926).

217. *Id.* at 447, *quoted in* Horsey, *supra* note 208, at 982.

218. *Bodell v. General Gas & Electric Corp.*, 5 A.2d 503, 510 (1939); see *infra* notes 300–01 and accompanying text.

care is not important because the issue is not the enforceability of the duty of care—that is a separate question—but only its existence.

Once consideration is extended beyond Delaware, it becomes abundantly clear that the corporate law duty of care existed long before the 20th century. The United States Supreme Court, for example, recognized a duty of care in 1891 in the case of *Briggs v. Spaulding*.<sup>219</sup> The Louisiana Supreme Court recognized the duty of care as far back as 1829, in the case of *Percy v. Millaudon*.<sup>220</sup> And in England, it was recognized as far back as 1742, in *Charitable Corp. v. Sutton*.<sup>221</sup> Considering that the modern corporation is itself not very old, it becomes clear that the duty of care has deep roots in corporate law after all.

Thus, although too much should not be made of the point, it is fair to say that the duty of care is well-established. Corporate law has developed on the assumption that there is a duty of care as well as a duty of loyalty. If we are to reconsider this development, we should do so cautiously and for good reasons.

### B. Deterrence

An enforceable duty of care is based primarily on a liability regime: shareholders can sue directors for breach of fiduciary duty (albeit in derivative actions), and directors may be held liable for damages. Perhaps the two most obvious benefits of a liability regime are compensation and deterrence: compensation of the injured party (the shareholder/beneficiary), and deterrence of misconduct by the actor (the director/fiduciary). Although both of these benefits may be applicable to the corporate law duty of care, the situation is admittedly complicated.

With respect to compensation, the situation is too complicated to warrant its inclusion as an argument in favor of the duty of care.<sup>222</sup> In the abstract, compensation for shareholders injured by the (gross) negligence of directors would be a good thing. And, at least in the absence of an exculpation provision in the corporate charter, compensation remains a possibility. However, the rate of recovery for shareholder-plaintiffs is much too low to argue that compensation plays a meaningful role in the corporate law duty of care paradigm.<sup>223</sup>

In fact, with respect to large public corporations, it would be impossible for compensation to play a major role. Corporate directors simply do not have the personal resources that would be needed to provide compensation for the harm that they are capable of inflicting through their negligence. Director negligence easily can cause billions of dollars of loss, while directors' wealth is usually measured only in the millions. Moreover, even in situations where directors could make shareholders whole, it would likely ruin the few directors in order to provide very small awards to huge numbers of shareholders—turning the normal tort vision of cost shifting on its head.<sup>224</sup>

Thus, compensation cannot be listed as an argument in favor of the corporate law duty of care. Deterrence, on the other hand, can and should. Although a liability regime may fall

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

220. *Percy v. Millaudon*, 8 Mart. (n.s.) 68 (La. 1829).

221. *Charitable Corp. v. Sutton*, 2 Atk. 400, 26 Eng. Rep. 642 (1742).

222. For a discussion of the limited role that compensation plays in corporate law, see *supra* 157–159 and accompanying text.

223. For a discussion of the low rates of recovery, see *supra* notes 6–10 and accompanying text.

224. See Velasco, *supra* note 13, at 832 & n.34.

short with respect to compensation, it nevertheless may have an important deterrent effect.

How deterrence works is not a mystery: if directors have to internalize the consequences of their (gross) negligence, they are less likely to be (grossly) negligent. Moreover, that there would be a deterrent effect is not in doubt: the possibility of ruinous liability would be a huge deterrent. One might be tempted to respond that the duty of care can't possibly have much of a deterrent effect because there simply isn't much risk of liability due to the business judgment rule. However, so great is the deterrent effect that it can even survive the deference of the business judgment rule. Because the potential liability is so great, the expected value of liability can be significant even when the likelihood of liability is low. Thus, for example, the lone case of *Smith v. Van Gorkom*<sup>225</sup> put fear into the hearts of directors everywhere.<sup>226</sup>

In fact, this is what makes the issue so complicated: the deterrent effect is simply too great. In the case of the corporate law duty of care, the risk of liability over-deters by a wide margin. Although we want directors merely to avoid negligence, directors are so risk averse that they would become overly cautious if we held them liable for negligence. They would not be willing to take on healthy entrepreneurial risks for fear of being second-guessed if things go wrong.<sup>227</sup> Because shareholders do not want timid directors, a liability regime could be unhelpful.

However, the risk of over-deterrence is not a good reason to abandon the duty of care. There is a very simple way to deal with the problem while retaining the benefits of deterrence: underenforcement by means of a deferential standard of review.<sup>228</sup> If enforcing a negligence standard will lead to overly cautious directors, then enforcing a lesser standard should be able to lead to the proper degree of care. This is what the business judgment rule does: it harnesses the deterrent effect of a liability regime to achieve the desired result. Through underenforcement of the duty of care, risk averse directors are led to act consistently with the higher standard of conduct—*i.e.*, the enforcement of a gross negligence standard rather than negligence leads directors to act with ordinary care rather than excessive caution.<sup>229</sup>

Admittedly, the argument is more strained in the face of exculpation provisions. When there is an exculpation provision, there may be no risk of liability at all. In this respect, the business judgment rule, with its low risk of liability, is superior to an exculpation regime, with no risk of liability.<sup>230</sup> However, even in a world of ubiquitous and robust exculpation provisions, an enforceable duty of care may still have a deterrent effect. In the first place, liability remains an option with respect officers, if not directors.<sup>231</sup> While cases against

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

226. *See supra* notes 54–55 and accompanying text (discussing reaction to the *Van Gorkom* case).

227. *See supra* notes 36–38 and accompanying text (discussing differing risk profiles of shareholders and directors); *see also* Velasco, *supra* note 4, at 549–50 (discussing how an excessively risk averse corporate director could negatively impact the entity's returns).

228. *See supra* notes 35–41, 105–111 and accompanying text (discussing the benefits of deferential review); *see also* Velasco, *supra* note 4, at 550–52 (arguing that “protect[ing] directors from honest mistakes on their part as well as from inevitable mistakes on the part of the legal system . . . empowers directors to pursue the interests of the corporation and its shareholders to the best of their abilities, without excessive fear of liability”).

229. *See* Velasco, *supra* note 4, at 551 (“Because imperfect litigation likely would lead to overenforcement of the standard of review, the result may not be so far from the appropriate level of enforcement for the standard of conduct.”).

230. *See supra* note 3 (noting author's view that exculpation provisions are sub-optimal).

231. *See supra* note 46 and accompanying text.

officers may be extremely rare, they remain a possibility. More significantly, many scholars believe that directors are deterred by judicial reprimands, regardless of the actual imposition of liability.<sup>232</sup> If so, the ability to seek such a reprimand, perhaps by way of declaratory judgment or in an action seeking an injunction, would give the duty of care some deterrent effect. Finally, it is possible to argue that directors remain liable for at least some care issues because of the enforceability of the duty of good faith.<sup>233</sup> In extreme cases, director nonfeasance can exceed the bounds of negligence and become conscious disregard of duty.<sup>234</sup> In such cases, exculpation is not available to directors. Moreover, as *Disney* demonstrates, courts can use such a case to opine on director shortcomings even if they ultimately do not hold directors liable.<sup>235</sup> Thus, although exculpation provisions may reduce the deterrent effect of the duty of care, they do not necessarily eliminate it altogether.

### C. The Duty of Loyalty Is Weak

Another reason to maintain the duty of care is based on the weakness of the existing duty of loyalty—at least, loyalty “as traditionally defined.”<sup>236</sup> If the duty of loyalty were sufficiently robust, there might be less of a need for the duty of care.<sup>237</sup> Although directors cannot be trusted when their interests conflict with those of shareholders, perhaps directors can be trusted when no conflict exists.<sup>238</sup> If the duty of loyalty were able to screen out all conflicts of interest, then the duty of care might be considered less necessary. The problem is that the duty of loyalty is not very strong at all.<sup>239</sup> Because it does not adequately screen out all conflicts of interests, the need for other avenues of enforcement remain.

Long ago, the duty of loyalty was much more robust: conflicts were essentially prohibited.<sup>240</sup> As Professor Harold Marsh noted long ago, “[i]n 1880 it could have been stated with confidence that in the United States the general rule was that any contract

232. This is taken up in a later section, as an independent argument in favor of the duty of care. *See infra* Part III.E.

233. *See infra* Part IV.C (discussing relationship between duty of care and duty of good faith).

234. *See In re Walt Disney Co. Derivative Litig.*, 906 A.2d 27, 63–67 (discussing distinction between negligence and bad faith).

235. *See, e.g., id.* at 56 (discussing “best practices” despite not holding directors liable).

236. *Id.* at 66. In *Stone v. Ritter*, the Delaware Supreme Court subsumed the duty of good faith within the duty of loyalty. As a “doctrinal consequence,” it concluded that “the fiduciary duty of loyalty is not limited to cases involving a financial or other cognizable fiduciary conflict of interest.” *Stone ex rel. AmSouth Bancorporation v. Ritter*, 911 A.2d 362, 370 (Del. 2006). For present purposes, I am setting aside this aspect of the duty of loyalty for two reasons. First, it is controversial. *See supra* notes 203–04 and accompanying text (discussing the shortcomings of *Stone v. Ritter*). Second, the duty of good faith involves intentional misconduct, rather than mere conflicts, and it is therefore far more difficult to prove a breach of the duty of good faith than the duty of loyalty (as traditionally defined). *See Velasco, supra* note 23, at 1248–50 (describing standards of review for the duty of good faith). The duty of good faith is taken up again in a later section. *See infra* Part IV.C.

237. Actually, there would still be a need. *See infra* Part III.D.

238. *See Velasco, supra* note 13, at 834 & n.42.

239. *Cf. Bainbridge et al., supra* note 200, at 568 (“[D]espite the rhetoric of enhanced scrutiny, we find evidence of the importance that Delaware corporate law places on deference to director decisions, even in cases implicating loyalty claims.”); Eisenberg, *supra* note 81, at 1276 (“Generally speaking, the legal sanctions for violating the duty of loyalty are inefficiently low.”).

240. *See Robert Cooter & Bradley J. Freedman, The Fiduciary Relationship: Its Economic Character and Legal Consequences*, 66 N.Y.U. L. REV. 1045, 1054 & n.23 (1991) (“Traditionally, a fiduciary was barred strictly from self-dealing.”) (citing cases).

between a director and his corporation was voidable at the instance of the corporation or its shareholders, without regard to the fairness or unfairness of the transaction.”<sup>241</sup> However, over time, the duty of loyalty was relaxed to allow conflicted transactions under increasing circumstances.<sup>242</sup> According to Marsh,

[b]y 1960 it could be said with some assurance that the general rule was that no transaction of a corporation with any or all of its directors was automatically voidable at the suit of a shareholder, whether there was a disinterested majority of the board or not; but that the courts would review such a contract and subject it to rigid and careful scrutiny, and would invalidate the contract if it was found to be unfair to the corporation.<sup>243</sup>

The deterioration of the rigor of the duty of loyalty has continued such that, by now, the duty of loyalty is only weakly enforced.

On its surface, the duty of loyalty appears to remain strong. Rather than granting the deference of the business judgment rule, loyalty issues invoke the much more demanding entire fairness test.<sup>244</sup> Not only do directors bear the burden of proof, but they must justify both their decision making process and the substance of their decisions.<sup>245</sup> And yet, the details paint a different picture.<sup>246</sup>

Despite the broad language with which the courts often describe the duty of loyalty,<sup>247</sup> the entire fairness test is not applied to all director conflicts. It is only applied to those that “rise to the level of self-dealing.”<sup>248</sup> “Classic examples of [self-dealing] involve either a director appearing on both sides of a transaction or a director receiving a personal benefit from a transaction not received by the shareholders generally.”<sup>249</sup> Although actual self-dealing is not a prerequisite, many conflicts that might be thought to compromise a director’s independence, such as friendship, are generally considered insufficient.<sup>250</sup> Generally, to be cognizable, a conflict must consist of either a personal or familial financial interest. Even so, not all financial conflicts will be sufficient to invoke the entire fairness test. The conflict must also be “material.”<sup>251</sup> A hypothetical or speculative conflict is

241. Marsh, *supra* note 192, at 36.

242. See generally *id.* at 36–48.

243. *Id.* at 36–48.

244. See *Nixon v. Blackwell*, 626 A.2d 1366, 1376 (Del. 1993) (“The entire fairness test essentially requires ‘judicial scrutiny.’”).

245. See *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983) (discussing the entire fairness test).

246. See generally *Velasco*, *supra* note 23, at 1242–43 (“[T]he entire fairness test is not quite as demanding as could be imagined.”); *Velasco*, *supra* note 13, at 853–54 n.137 (“It is not clear that the entire fairness test is quite as strict as judicial statements suggest.”).

247. See, e.g., *Meinhard v. Salmon*, 164 N.E. 545, 546 (N.Y. 1928) (using language such as “the punctilio of an honor the most sensitive” to describe the duty of loyalty); *Guth v. Loft*, 5 A.2d 503, 510 (Del. 1939) (stating that the duty of loyalty is “the most scrupulous observance of . . . [one’s] duty”); *Weinberger*, 457 A.2d at 710 (defining the duty of loyalty as “the utmost good faith and the most scrupulous inherent fairness”).

248. *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 363 (Del. 1993) (citing *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1983)). See also *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del. 1971) (“[The intrinsic fairness standard] will be applied only when the fiduciary duty is accompanied by self-dealing . . .”).

249. *Cede & Co.*, 634 A.2d at 362. See also *Sinclair*, 280 A.2d at 720.

250. See *Beam v. Stewart*, 845 A.2d 1040, 1050 (Del. 2004) (“Not all friendships, or even most of them, rise to this level and the Court cannot make a *reasonable* inference that a particular friendship does so without specific factual allegations to support such a conclusion.”).

251. *Cede & Co.*, 634 A.2d at 362–64.

insufficient.<sup>252</sup> Furthermore, approval by disinterested directors can sanitize conflicts of individual directors<sup>253</sup>—even though structural bias arguably prevents those directors from being considered reliable arbiters.<sup>254</sup> In fact, a plaintiff generally must show that a majority of the directors are conflicted under these forgiving standards.<sup>255</sup>

Once applied, the entire fairness test is no longer considered outcome-determinative.<sup>256</sup> It does not require that a director's conduct be perfect, only that it be fair.<sup>257</sup> In fact, the Delaware Court of Chancery has increasingly taken to speaking of a "range of fair value."<sup>258</sup> This is a far cry from "the most scrupulous inherent fairness" that courts used to speak of.<sup>259</sup> In fact, the courts have even held that a transaction can be considered entirely fair in the face of gross negligence<sup>260</sup>—a holding that may not be logically impossible, but is at least troubling.<sup>261</sup>

Clearly, the duty of loyalty as it exists in corporate law is not all that strong. It does not even purport to capture all conflicts of interest, and does not do a very thorough job on those it does. Of course, there may be good reasons for limiting the scope of the duty of loyalty.<sup>262</sup> However, it is important to acknowledge that the scope is very limited. Recognizing these limits can help to prevent instances of over-claiming.

252. Even a director's interest in maintaining his position on the board in the face of a hostile takeover may not be sufficient. *See Am. Gen. Corp. v. Unitrin, Inc. (In re Unitrin, Inc. S'holders Litig.)*, Nos. 13656, 13699, 1994 Del. Ch. LEXIS 187, at \*13 (Del. Ch. Oct. 13, 1994) ("The board's interest in employing these defensive measures to deflect [a hostile] offer does not rise to the level of a self-dealing transaction that requires the board to demonstrate entire fairness."); *City Capital Assocs. Ltd. P'ship v. Interco Inc.*, 551 A.2d 787, 790 n.1 (Del. Ch. 1988) ("While the recapitalization does represent a transaction in which the 14 person board (and most intensely, its seven inside members) has an interest . . . it does not represent a self-dealing transaction in the sense necessary to place upon the board the heavy burden of the intrinsic fairness test.").

253. DEL. CODE ANN., tit. 8 § 144 (2010).

254. *See generally* Velasco, *supra* note 13 (discussing directors and structural bias).

255. *Stewart*, 845 A.2d at 1049; *Grimes v. Donald*, 673 A.2d 1207, 1216 (Del. 1996).

256. *See Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1156, 1163 (Del. 1995) ("[A]n initial judicial determination that a given breach of a board's fiduciary duties has rebutted the presumption of the business judgment rule does not preclude a subsequent judicial determination that the board action was entirely fair, and is, therefore, not outcome-determinative *per se.*"); *Nixon v. Blackwell*, 626 A.2d 1366, 1376 (Del. 1993) ("It is sometimes thought that the decision whether to apply the business judgment rule or the entire fairness test can be outcome-determinative . . . . Application of the entire fairness rule does not, however, always implicate liability of the conflicted corporate decisionmaker, nor does it necessarily render the decision void.").

257. *See Cinerama*, 663 A.2d at 1179 ("A finding of perfection is not a *sine qua non* in an entire fairness analysis."); *Weinberger v. UOP, INC.*, 457 A.2d 701, 709 n.7 (stating that "perfection is not possible, or expected").

258. *See, e.g., Reis v. Hazelett Strip-Casting Corp.*, 28 A.3d 442, 465 (Del. Ch. 2011) ("When conducting a fair price inquiry as part of the entire fairness standard of review, the court asks whether the transaction was one 'that a reasonable seller, under all of the circumstances, would regard as within a range of fair value; one that such a seller could reasonably accept.'" (quoting *Cinerama*, 663 A.2d at 1143)).

259. *Weinberger*, 457 A.2d at 710. While it is undoubtedly true that fair value can be considered to be a range rather than a point, that is irrelevant. There is a minimum point of fairness: anything below it would be considered unfair to the shareholders; anything above that would be considered fair, even if it is in fact too generous. Thus, shifting the rhetoric from "the most scrupulous inherent fairness" to a "range of fair[ness]," serves only one purpose: to water down the standard of review. Courts no longer have to determine whether a given price is "entirely" fair, but only whether it is in the ballpark.

260. *See, e.g., Cinerama*, 663 A.2d at 1179–80.

261. *See Velasco, supra* note 13, at 853–54 & n.137. *Cf. Cinerama*, 663 A.2d at 1140 ("I recognize the force of the claim that a process that is uninformed can never be fair to shareholders.").

262. *See, e.g., Rock & Wachter, supra* note 59, at 663–71 (discussing why corporate law grants directors flexibility, even as to loyalty issues).

Even if it is true that unconflicted directors can be trusted, “the fact that a shareholder cannot establish self-dealing does not mean that directors were not conflicted[.]”<sup>263</sup> There are conflicts that courts refuse to recognize under the duty of loyalty. Although such conflicts may not warrant review under the entire fairness test, they do not deserve to be immunized from further review, either. We might be willing to let negligence—even gross negligence—slide if we were confident that directors are not conflicted. However, when we are not so confident, it becomes more important to police at least the worst cases of negligence.

Thus, an important reason to retain the duty of care is that the duty of loyalty is only weakly enforced. Defendants who survive scrutiny under the duty of loyalty cannot be said, with any confidence, to be unconflicted. Therefore, they should not be shielded from review under the duty of care.

#### *D. The Duty of Loyalty Is Not Enough*

Another reason to preserve the duty of care is that the duty of loyalty is simply insufficient to do the work of policing fiduciary relationships. Once fiduciary duties are put in the context of fiduciary relationships, it becomes evident that the concept of loyalty, while certainly important, does not adequately address the issues raised by fiduciary relationships. The concept of care, or diligence, is also necessary.

What is a fiduciary duty? It is not so much a special type of duty as it is a duty imposed in a special kind of relationship. A fiduciary relationship is a legally recognized relationship in which one is given power over the interests of another, who thereby becomes vulnerable to abuse. Although such relationships are risky, they can also be very beneficial. In order to encourage and police such relationships, the law imposes a duty on the first party—the fiduciary—to act in the interests of the second party—the beneficiary (who is often, but not always, the entrustor, or the party granting the power to the first). Thus, the *raison d’être* of fiduciary duties, and of the designation of relationships as fiduciary, is the protection of the beneficiary from abuse at the hands of the fiduciary.<sup>264</sup>

Of course, one way in which the fiduciary might abuse the beneficiary is to use his fiduciary powers to benefit himself rather than the beneficiary. This is clearly prohibited by the duty of loyalty. However, this is not the only concern in a fiduciary relationship. As Professor Robert Cooter put it,

[t]he fiduciary relationship exposes a beneficiary/principal to two distinct types of wrongdoing: first, the fiduciary may misappropriate the principal’s asset or some of its value (an act of malfeasance); and second, the fiduciary may neglect the asset’s management (an act of nonfeasance). Each type of wrongdoing is controlled by imposing a legal duty upon the fiduciary. The former—misappropriation—is governed by the duty of loyalty, and the latter—negligent mismanagement—is governed by the duty of care.<sup>265</sup>

Loyalty is important. However, it is not necessarily the primary concern in a fiduciary

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263. Velasco, *supra* note 23, at 1255.

264. Velasco, *supra* note 171, at 159 (citations omitted).

265. Cooter & Freedman, *supra* note 240, at 1047.

relationship. Of primary importance is that the fiduciary does a good job—exercising all their skill with the appropriate diligence.<sup>266</sup> This is the domain of the duty of care, which protects beneficiaries from fiduciary shirking. The possibility of a conflict of interests is very often only a secondary or theoretical concern for the beneficiary.

Of course, there are other considerations that make the duty of care a less pressing concern than the duty of loyalty, especially in the corporate context. For example, while care issues may be ubiquitous, conflicts of interest are more significant when they do exist. Moreover, market forces and competition do a better job at limiting a director's ability to shirk than at curbing the incentives to engage in self-dealing.<sup>267</sup> So while the duties of care and loyalty may be equally important as a conceptual matter, they are not equal priorities as a practical matter. Nevertheless, care concerns should not be discounted.

Moreover, care issues are not so categorically different than loyalty issues. In many cases, one can be recast as the other.<sup>268</sup> For example, shirking can be considered negligent behavior, or as a conflict of interest regarding the director's time and energy. In the latter sense, shirking becomes a form of self-dealing: directors have to decide whether to spend their time and effort on business matters, for the benefit of shareholders, or reserve it for personal matters, for their own benefit.<sup>269</sup> Conceptualized in this way, care and loyalty issues arguably differ in degree rather than kind.

For the courts to interpret care issues in this way would be problematic: it would undermine some of the basic premises of corporate law and invite the heavy scrutiny of the entire fairness test in many, if not all, cases. That would be as unwise as it is unlikely. However, the realization that care issues are not so dissimilar to loyalty issues should give pause to those who would eliminate of the duty of care.

In short, the duty of loyalty—at least in its current form—is insufficient to police fiduciary relationships. The duty of care is necessary, among other reasons,<sup>270</sup> to pick up its slack. Ultimately, fiduciaries must pursue the interests of the beneficiaries, and this concern extends beyond cognizable loyalty issues.

#### E. The Expressive Value of Law

A final reason why the duty of care should not be eliminated is because of the expressive and pedagogical effect of law.<sup>271</sup> The law does more than issue penalties for

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266. This argument is based on personal instinct and anecdotal evidence from discussing the issue with others. People tend to be more concerned with care issues than with loyalty issues when seeking professional assistance.

267. See *supra* note 125 and accompanying text.

268. Cf. *supra* note 23 and accompanying text.

269. See Cooter & Freedman, *supra* note 240, at 1056 (“[T]he fiduciary who shirks, in effect, appropriates effort owed to the principal.”); Claire A. Hill & Brett H. McDonnell, *Stone v. Ritter and the Expanding Duty of Loyalty*, 76 *FORDHAM L. REV.* 1769, 1795 (2007) (“Classic duty of care cases also involve a director taking for herself something which should otherwise be the corporation’s: her attention and diligence.”).

270. I do not mean to suggest that the main purpose of the duty of care is to serve as a backstop for the duty of loyalty. My argument is only that *another* reason to maintain a meaningful duty of care—in addition to its own intrinsic value—is that we do not have a sufficiently robust duty of loyalty.

271. See generally Lawrence Lessig, *Social Meaning and Social Norms*, 144 *U. PA. L. REV.* 2181 (1996) (explaining the importance of social meaning in the law); Lawrence Lessig, *The Regulation of Social Meaning*, 62 *U. CHI. L. REV.* 943 (1995) (describing the role of social construction in law); Richard H. McAdams, *The Origin, Development, and Regulation of Norms*, 96 *MICH. L. REV.* 338 (1997) (discussing how social norms “develop more robust explanations of behavior and . . . predict more accurately the effect of legal rules”); Cass

the violation of its mandates. By telling people what is required of them, the law influences personal morality. Thus, for example, people may be more inclined to believe that conduct is morally acceptable if it is legal and to believe that it is morally unacceptable if it is illegal.<sup>272</sup> Moreover, people often obey the law simply because it is the law.<sup>273</sup> As a result of these effects, the existence of the duty of care can have the effect of making corporate managers more diligent. Conversely, the elimination of the duty of care sends the signal that diligence is not important and could have the effect of making corporate managers less diligent.<sup>274</sup>

Many corporate law scholars recognize that the law of fiduciary duties can have a positive value entirely independent of legal enforcement.<sup>275</sup> An especially popular view is that judicial opinions can influence director behavior, even without a formal legal sanction, simply by letting directors know what they might have done differently.<sup>276</sup> In other words,

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R. Sunstein, *On the Expressive Function of Law*, 144 U. PA. L. REV. 2021 (1996) (discussing the significance of expressive content in laws, explaining that laws serve to say who we are as a people as much as they may serve a deterrence effect).

272. See, e.g., Robert E. Goodin, *An Epistemic Case for Legal Moralism*, 30 OXFORD J. LEGAL STUD. 615, 629 (2010) (noting that citizens may rely on the inference that illegality and immorality are coextensive).

273. See TYLER, *supra* note 132, at 170 (“People generally feel that existing legal authorities are legitimate, and this legitimacy promotes compliance with the law.”). See also Eisenberg, *supra* note 81, at 1270 (“[T]he general norm of obedience to law . . . is one of the most powerful norms of our society.”).

274. See Bruner, *supra* note 57, at 1053 (“[C]alling the duty of care a ‘fiduciary’ duty for decades and then abruptly restyling it as something else might be misinterpreted by the marketplace as a de facto demotion—undercutting compliance stemming from motivations other than fear of monetary damages.”).

275. See, e.g., Eisenberg, *supra* note 81, at 1269 (“[M]any legal rules have an expressive effect—that is, in addition to their regulatory effects, legal rules send messages of various kinds.”); Coffee, *supra* note 17, at 798 (“In my view, what is most desirable about the duty of care is its socializing and exhortative impact.”); Rock & Wachter, *supra* note 73, at 1623 (“The duty of care, despite looking like a typical legally enforceable standard of care, actually is best understood as an NLERS [*i.e.*, non-legally enforceable rules and standards], with the business judgment rule assuring that enforcement is almost entirely nonlegal.”).

276. See *supra* notes 83–87 and accompanying text (suggesting judicial opinions essentially put directors on notice as to what behavior is acceptable); see also Margaret M. Blair & Lynn A. Stout, *Trust, Trustworthiness, and the Behavioral Foundations of Corporate Law*, 149 U. PA. L. REV. 1735, 1744 (2001) (“By articulating a social expectation that directors will exercise due care, judicial opinions on the duty of care may influence directors’ behavior not so much by changing their external incentives as by changing their internal preferences.”); Hill & McDonnell, *supra* note 269, at 1794 (“Extralegal forces—norms and reputation—play a very strong role in the behavior of corporate actors. Delaware courts are clearly aware of this function, and employ it to encourage behavior they find desirable but that would be difficult to address more directly through law itself.”); Coffee, *supra* note 17, at 796 (discussing an “important consequence of the judicial dicta that has elaborated on the nature of the duty: its educational and socializing effect”); Rock, *supra* note 78, at 1013 (“[T]he Delaware courts provide a supplemental source of gossip, criticism, and sanction for this set of actors who are beyond the reach of the firm’s normal systems of social control.”); Eisenberg, *supra* note 81, at 1270 (“The clarifying function of legal rules has obvious relevance to the duty of care, because one function of the cases that clarify the meaning of that duty, especially in a directorial context, is to tell directors how to play their directorial role . . . . Having been so instructed, directors who wanted to perform their role properly made appropriate adjustments in their conduct—not necessarily to avoid liability, but just because they wanted to play their roles properly.”). Various Delaware judges have expressed a similar view. See, e.g., Veasey & Di Guglielmo, *supra* note 13, at 1406 (“[A]n opinion that raises questions or teaches without imposing liability may provide guidance to the corporate world to conform to best practices without the downside of actually imposing personal liability.”); Myron T. Steele & J.W. Verret, *Delaware’s Guidance: Ensuring Equity for the Modern Witenagemot*, 2 VA. L. & BUS. REV. 189, 207 (2007) (“[T]he Delaware judges have frequently crafted dicta to give valuable guidance to deal lawyers on unanswered questions.”); William T. Allen, *The Corporate Director’s Fiduciary Duty of Care and the Business Judgment Rule Under U.S. Corporate Law*, in COMPARATIVE CORPORATE GOVERNANCE 307, 328 (Klaus J. Hopt et al. eds.,

the courts can help to establish and encourage social norms with which directors will generally comply.<sup>277</sup>

To be fair, there is diversity of opinion on how social norms should operate. Some scholars, such as Professor Eisenberg, believe that legal forces and extra-legal forces can work together to achieve compliance with the desired social norms.<sup>278</sup> Others, such as Professors Rock and Wachter, believe that the legal enforcement ought not to play a role, at least when it comes to the duty of care.<sup>279</sup> Either way, the existence of the duty of care is necessary to get the benefit of this expressive effect of law.

In fact, an enforceable duty of care is likely to be much more effective in this regard than an unenforceable duty of care. This is true for two reasons. First, most people obey the law out of a mixture of different motivations, and fear of punishment is one of those motives.<sup>280</sup> As previously discussed, the potential for liability for breach of the duty of care can have a significant deterrent effect.<sup>281</sup> This possibility will cause directors to pay a little more attention to the standards articulated by the courts.<sup>282</sup> A related benefit is that directors are more likely to believe that other directors are complying with the law, and as a result are more likely to comply themselves.<sup>283</sup>

Second, the courts generally need a potentially-enforceable duty of care in order to articulate standards of conduct. Consider Rock's account of how the corporate law of fiduciary duties is developed:

[T]he Delaware courts generate in the first instance the legal standards of conduct (which influence the development of the social norms of directors, officers, and lawyers) largely through what can best be thought of as "corporate law sermons." These richly detailed and judgmental factual recitations, combined with explicitly judgmental conclusions, sometimes impose legal sanctions but surprisingly often do not. Taken as a whole, the Delaware opinions can be understood as providing a set of parables—instructive tales—of good managers

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1998) ("This unclarity [concerning the duty of care and its enforcement] offers the possibility that the legal system may extract some of the benefits of encouraging director attentiveness, while avoiding the worst elements of the efficiency costs that actually imposing liability on directors would entail.").

277. See, e.g., Eisenberg, *supra* note 81, at 1265 ("The level of directorial care is largely driven by social norms, rather than by the threat of liability or the prospect of gain."); Claire Hill & Brett McDonnell, *Executive Compensation and the Optimal Penumbra of Delaware Corporation Law*, 2 VA. L. & BUS. REV. 333, 363 (2009) ("[T]hat is what people often do: they follow norms."); Rock, *supra* note 78, at 1013 ("[A]ll of us internalize rules and standards of conduct with which we generally try to comply.").

278. See, e.g., Eisenberg, *supra* note 81, at 1269. See also Hill & McDonnell, *supra* note 276, at 360.

279. See Rock & Wachter, *supra* note 73, at 1685.

280. See TYLER, *supra* note 132, at 3–5 (discussing four factors that motivate people to obey the law).

281. See *supra* Part III.B.

282. See Hill & McDonnell, *supra* note 277, at 362 ("By engaging in the kind of best practices praised by Delaware judges, even though doing so is not required, officers and directors reduce to nearly zero the already extremely small chances of legal liability."); Rock, *supra* note 78, at 1103 ("[T]he 'thick-skinned' businessman [who] wants to skate close to the edge . . . will . . . [probably not] be constrained by the possibility that he will go down in history as a villain of Delaware corporate law . . . . But his lawyer is likely to advise him that such behavior will make it more likely that the deal will be enjoined, or that he will be left unprotected against maneuvers by his opponents.").

283. See STOUT, *supra* note 132, at 99 ("[U]nselfish compliance with legal and ethical rules . . . is triggered by social context, including . . . belief about others' prosocial behavior . . ."). Cf. Eisenberg, *supra* note 81, at 1270 ("[T]he adoption of a legal rule, even without formal enforcement, can cause actors to correctly believe that there will be more social enforcement of the norm.").

and bad managers, of good lawyers and bad lawyers, that, in combination, fill out the normative job description of these critical players. My intuition is that we come much closer to understanding the role of courts in corporate law if we think of judges more as preachers than as policemen.<sup>284</sup>

This model does not require legal *enforcement* to function. Nevertheless, it does require legal *enforceability*. If a standard is entirely unenforceable, then shareholders will be unable to bring it before the court. Without any occasion to opine on the standard, the courts will be unable to deliver their “sermons.” Without those sermons, standards cannot be articulated and social norms cannot be influenced. Thus, the duty of care must be enforceable, even if only barely, in order for this expressive effect to work.<sup>285</sup>

To be clear, I do not mean to suggest that the purpose of the duty of care is to facilitate sermonizing by the courts. In my opinion, “[i]t is . . . the province and duty of the [judiciary] to say what the law is,”<sup>286</sup> not to give sermons. Courts are legal experts, not moral experts. They have no special authority to demand that litigants and other affected people go above and beyond the requirements of the law. Thus, there is something objectionable to Rock’s view of judges as more “preachers” than “policeman”—at least to the extent that one views the law as comprising the standard of review, and standards of conduct as mere aspirational fluff.<sup>287</sup> What I mean to defend is the practice of judicial articulation of what the law *requires* of directors and other fiduciaries, regardless of whether those requirements will be enforceable by monetary damages. The difference between sermonizing and opining, as I see it, is that a sermon tells someone what they morally ought to do (but legally need not do), while an opinion tells them what they legally must do (even if the consequences will be limited). It is the expressive value of the law itself that matters, not the expressive value of the judiciary.

Of course, the expressive value of the law is a double-edged sword in corporate law. Given the lack of legal enforceability, one could easily perceive the law to be expressing ambivalence at best, and lack of concern at worst, with respect to the duty of care.<sup>288</sup> This is a legitimate concern, and one that would support greater enforcement, but it is a concern that is outweighed by the justifications for the business judgment rule. The solution is to have the courts clearly articulate the reasons for the underenforcement of the duty of care. If a court suggests that a negligent director should have done better but did not breach his duty of care (because he was not grossly negligent)—as the court seemed to do in *Disney*<sup>289</sup>—it is, at best, sermonizing. This is unlikely to have the intended effect because directors could just as easily read such an opinion to be saying that they need not worry about the duty of care because it is very difficult to breach. On the other hand, a court could conclude that a negligent director breached his fiduciary duty but, under the business

284. Rock, *supra* note 78, at 1016.

285. As I suggest later in this Article, care-type issues survive under the auspices of the duty of good faith. *See infra* Part IV.C. Thus, even without an enforceable duty of care, it is possible for the courts to sermonize (or opine) on issues of director diligence—as they did in *Disney*. However, it is doubtful whether one could get good opinions on negligence issues when the issue being litigated is limited to intentional misconduct.

286. *Marbury v. Madison*, 5 U.S. 137, 177 (1803).

287. *See Velasco, supra* note 4, at 524–38 (describing “aspirational view” of fiduciary duties).

288. *See supra* note 87 and accompanying text (offering alternative interpretations of judicial deference).

289. *See, e.g., In re Walt Disney Co. Derivative Litig.*, 906 A.2d 27, 73 (Del. 2006) (“Even though the Chancellor found much to criticize in Eisner’s ‘imperial CEO’ style of governance, . . . in the end, Eisner’s conduct satisfied the standards required of him as a fiduciary.”).

judgment rule, would not be held liable because the plaintiff could not establish gross negligence. This sends a clearer message that the duty of care was breached and is more likely to have the effect of causing directors to pay attention. The difference may seem slight, but it is potentially of great significance. In the first example, it is clear that the directors have done nothing wrong as a legal matter, but that the court would prefer for them to strive to do better. In the second example, it is clear that the directors have breached their duties, and that they are not being held liable for other reasons. The desire to comply with the law would become a motivating factor in the latter instance, and not in the former.

In short, the duty of care should be maintained because of the expressive effects of the law. Even without regard to actual legal enforcement, the existence of a duty of care can lead to enhanced director diligence. However, minimal enforceability seems to be necessary to capitalize on this benefit.

#### IV. WHY IT MATTERS

The goal of this Article is to provide a defense of the fiduciary duty of care as it currently exists in corporate law: a fiduciary duty that is demanding in principle but deliberately underenforced by the courts. In Part II, I considered various arguments commonly raised against the duty of care. I sought to establish that, although the arguments generally support the claim that the duty of care ought not to be enforced rigorously, they do not support the claim that the duty of care should be eliminated. In Part III, I considered various arguments that can be raised in favor of the duty of care. I sought to establish that there are many good reasons for retaining an underenforced duty of care.

I now consider why the issue matters. If there are good arguments for and against the duty of care and the question is whether it should be enforced lightly or eliminated altogether, the stakes may not seem to be very high. However, this appearance is deceptive. The question of whether we retain or eliminate a modest duty of care goes to the heart of fiduciary principles in corporate law. It serves as a proxy for the larger question of whether we should see fiduciary duties as providing a secure foundation for a meaningful fiduciary relationship or merely as another set of technical requirements that managers must navigate.

In this Part, I will argue the former position. First, I will show that the fiduciary principle is broad and expansive, and cannot be boiled down to a few simple rules. Then I will argue that the urge to simplify the law of fiduciary duties is misguided. Finally, I will suggest that, in the long run, the courts will tend to resist the reductionist impulse to simplify at the expense of equity. Thus, it is better to accept the duty of care and deal with it directly than to attempt to eliminate it and invite judicial innovation.

##### *A. Fiduciary Principles Are Inherently Broad*

What are the basic principles of fiduciary law? This is a controversial question. Scholars do not agree on the source of fiduciary law, and many are skeptical about whether fiduciary law can be adequately defined.<sup>290</sup> Nevertheless, there is agreement on at least the most basic principles of fiduciary law. “At its core, a fiduciary relationship is one in which one party—the fiduciary—is trusted with power over the interests of another—the

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290. See Velasco, *supra* note 171, at 160 (discussing scholarly debate).

beneficiary—who becomes vulnerable as a result.”<sup>291</sup> Because of the vulnerability inherent in a fiduciary relationship, trust becomes an important concept in fiduciary law. “[T]he essence of a fiduciary relationship is the legal expectation that the fiduciary will adopt the other-regarding preference function that is the hallmark of trustworthy behavior.”<sup>292</sup> To facilitate trust, the law imposes upon the fiduciary a special obligation to act in the interests of the beneficiary. The exact nature of this special obligation varies upon the circumstances. In corporate law, there seems to be a duty of care, a duty of loyalty, and some sort of duty of good faith.<sup>293</sup> However, as Professors Claire Hill and Brett McDonnell have argued, fiduciary duties can be understood at different levels of abstraction.<sup>294</sup> At the highest level of abstraction, there is only one fiduciary duty: a duty to pursue the interests of the beneficiary.<sup>295</sup> This view most clearly reveals the true nature of fiduciary duties. The duties of care, loyalty, and good faith are simply manifestations of this one duty at lower levels of abstraction: the duty of care represents the duty to pursue the interests of the beneficiary *carefully*; the duty of loyalty represents the duty to pursue the interests of the beneficiary *loyally*; and the duty of good faith represents the duty to pursue the interests of the beneficiary *honestly*.<sup>296</sup> “Both generally and in each case, the purpose of fiduciary duties is to protect beneficiaries from abuse at the hands of the fiduciary.”<sup>297</sup>

Properly understood, fiduciary duty is a pervasive concept. Enforcement issues aside, the courts agree. According to the Delaware Supreme Court, “fiduciary duty does not operate intermittently but is the constant compass by which all director actions for the corporation . . . must be guided.”<sup>298</sup> The court has often described the directors’ fiduciary duty as “unremitting.”<sup>299</sup> Moreover, fiduciary duty also extends beyond negative

291. *Id.* at 161. *See also* TAMAR FRANKEL, FIDUCIARY LAW 4 (2011) (“[T]he definitions of fiduciaries . . . share three main elements: (1) entrustment of property or power, (2) entrustors’ trust of fiduciaries, and (3) risk to the entrustors emanating from the entrustment.”); DeMott, *supra* note 149, at 936 (“The defining or determining criterion should be whether the plaintiff (or claimed beneficiary of a fiduciary duty) would be justified in expecting loyal conduct on the part of an actor and whether the actor’s conduct contravened that expectation.”); Smith, *supra* note 160, at 1402 (“[F]iduciary relationships form when one party . . . acts on behalf of another party . . . while exercising discretion with respect to a critical resource belonging to the [other].”); J.C. SHEPHERD, THE LAW OF FIDUCIARIES 35 (1981) (“A fiduciary relationship exists whenever any person acquires a power of any type on condition that he also receive with it a duty to utilize that power in the best interests of another[.]”); Paul B. Miller, *Justifying Fiduciary Duties*, 58 MCGILL L.J. 969, 1011 (“A fiduciary relationship is one in which one party . . . exercises discretionary power over the significant practical interests of another[.]”).

292. Blair & Stout, *supra* note 276, at 1743.

293. *See* Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 361 (Del. 1993) (discussing the “triads of . . . fiduciary duty”); Stone *ex rel.* AmSouth Bancorporation v. Ritter, 911 A.2d 362, 370 (Del. 2006) (demoting duty of good faith to subset of loyalty). In other work, I have also argued that Delaware law can be interpreted to provide for two additional duties: a duty of objectivity, covering situations involving structural bias and reviewed for reasonableness, and a duty of rationality, covering the substance of business decisions and reviewed for waste. *See* Velasco, *supra* note 23, at 1235.

294. *See* Hill & McDonnell, *supra* note 269, at 1788–89.

295. *See id.* at 1788 (“At the very highest level, there is just one fiduciary duty—to pursue faithfully and diligently the best interests of the corporation and its shareholders.”). *See also* Leo E. Strine Jr. et al., *Loyalty’s Core Demand: The Defining Role of Good Faith in Corporation Law*, 98 GEO. L.J. 629, 635 (2010) (“[I]t is possible to conceive of there being only one core duty[.]”); Velasco, *supra* note 23, at 1281–84 (discussing “one fundamental fiduciary duty”).

296. *See* Velasco, *supra* note 23, at 1301.

297. Velasco, *supra* note 171, at 163.

298. *Malone v. Brincat*, 722 A.2d 5, 10 (Del. 1998).

299. *See, e.g., id.*; *Omnicare, Inc. v. NCS Healthcare*, 818 A.2d 914, 938 (Del. 2003); *Quickturn Design*

prescription and includes an affirmative component.<sup>300</sup> This was eloquently described long ago, in the seminal case of *Guth v. Loft*:

A public policy, existing through the years, and derived from a profound knowledge of human characteristics and motives, has established a rule that demands of a corporate officer or director, peremptorily and inexorably, the most scrupulous observance of his duty, not only affirmatively to protect the interests of the corporation committed to his charge, but also to refrain from doing anything that would work injury to the corporation, or to deprive it of profit or advantage which his skill and ability might properly bring to it, or to enable it to make in the reasonable and lawful exercise of its powers.<sup>301</sup>

This, of course, is entirely sensible. It is responsive to the nature of the fiduciary relation. A beneficiary needs a fiduciary who is pursuing the beneficiary's interests—actively, honestly, at all times, and in all respects relevant to the relationship. Anything less would undermine the trust that is the foundation of the fiduciary relationship. Therefore, this is what the law demands of fiduciaries.<sup>302</sup>

This claim may seem excessive in light of the limited nature of judicial enforcement of fiduciary duties generally and the duty of care in particular. However, the claim is made advisedly. This is what the law demands of fiduciaries. What the courts will enforce is a separate matter.<sup>303</sup> Enforcement is an issue that involves many practical considerations. Some of those considerations may be general enough to affect all of fiduciary law; others are unique to the corporate law context. For the various reasons discussed throughout this Article, corporate law has settled upon deferential review. But this decision does not affect the underlying principles that animate fiduciary law.

Fiduciary duty is a broad concept that encompasses all of the individual fiduciary duties. Thus, the duty of care is not a separate duty, unrelated to loyalty, that can easily be eliminated. To the contrary, it is intimately related to the duty of loyalty: different in many respects, but also fundamentally similar. Care and loyalty could be thought of as siblings: each unique and yet both part of the same immediate family. Their true relationship, however, is even closer than that analogy suggests. Care and loyalty—and good faith, as well as any other fiduciary duties—are different manifestations of the one fiduciary duty. Therefore, the duty of care cannot be eliminated without doing violence to the framework of fiduciary duties (and, ultimately, to the duty of loyalty). It would be incoherent to maintain that fiduciary duty requires directors to pursue the interests of the corporation and its shareholders in all relevant respects *except diligence*. Diligence is highly relevant, and to deny the duty of care is to deny that fiduciary duty is pervasive.

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Sys., Inc. v. Shapiro, 721 A.2d 1281, 1292 (Del. 1998).

300. See Strine et al., *supra* note 295, at 635 (“[W]e think it uncontroversial that the corporate law duty of loyalty has an affirmative aspect, which demands that a fiduciary make a good faith effort to advance the best interests of the corporation and its stockholders.”).

301. *Guth v. Loft*, 5 A.2d 503, 510 (Del. 1939). See Velasco, *supra* note 23, at 1262–63 (discussing how “most of the passage [quoted above] actually deals with fiduciary duties generally, rather than the duty of loyalty specifically”).

302. Cf. Miller, *supra* note 172, at 75 (“Fiduciary duties constrain the conduct of the fiduciary within the ambit of the relationship so ascertained, but not beyond it.”).

303. See generally Velasco, *supra* note 4, at 571–80 (discussing “[t]he viability of the unenforced requirement”).

*B. Oversimplification*

As a matter of positive law, there is a corporate law duty of care.<sup>304</sup> However, the duty is enforced weakly, at best. For the most part, directors face almost no risk of personal liability for breach of the duty of care. Why, then, is there any interest in eliminating the duty? It is not because of any pressing need:<sup>305</sup> at the present time, there is no crisis as there once may have been.<sup>306</sup>

A recurring theme among scholars who write in corporate law is the desire to simplify. There are many who believe that the law of fiduciary duties has continuously grown to the point where it has become too complex.<sup>307</sup> According to this view, the law needs significant pruning.<sup>308</sup> While this attitude is usually directed towards intermediate standards of review, some consider the duty of care to be a doctrine that is expendable.<sup>309</sup> There is a similar sense among some scholars writing about fiduciary law generally. Among some, there is a willingness to declassify the duty of care as fiduciary and limit fiduciary duty to a prohibition against conflicts of interest.<sup>310</sup> I reject these views for three reasons.

First, the law of corporate fiduciary duties is not overly complex.<sup>311</sup> Corporate officers and directors are sophisticated people who generally also have access to legal advice. If they can manage multibillion-dollar transactions and corporate reorganizations, they likely can juggle a handful of fiduciary duties. At the very least, they can handle more than just one—and while the loyalty may be first on the list of fiduciary duties, care would be second. Moreover, if corporate managers cannot handle more than one fiduciary duty, they need only keep in mind the one fundamental duty to pursue the interests of the shareholders. In short, the problem of complexity is more imagined than real.

Second, the complexity that exists is both inevitable and, to some extent, actually desirable to management. As previously discussed, the law of fiduciary duties is standards-based, rather than rules-based.<sup>312</sup> However, as the law of fiduciary duties develops in a common-law process, general principles get applied to particular circumstances and the standards start to take on the characteristics of rules.<sup>313</sup> The process is inevitable: even if

304. See *supra* Part III.A (discussing pedigree of the corporate law duty of care).

305. See Bruner, *supra* note 57, at 1029 (“I ultimately concede that there may be no pressing imperative to restyle the duty of care in nonfiduciary terms moving forward—and that there may in fact be good reasons not to do so[.]”).

306. See *supra* notes 54–55 and accompanying text.

307. See, e.g., Allen et al., *supra* note 15, at 1291–95 (discussing “protean growth in . . . judicial standards of review”); Bruner, *supra* note 57, at 1031 (“Delaware’s doctrinal structure . . . has, since the 1980s, continually grown by accretion, piling complexity upon complexity[.]”). See also Velasco, *supra* note 13, at 845 (“intermediate standards [of review] . . . multipl[ie]d rather than coalesce[d]”).

308. See, e.g., Allen et al., *supra* note 15, at 864–65 (undertaking “a rigorous functional evaluation of existing corporate law standards of review” in order to “clarify their application, reduce their number, and facilitate the task of corporate advisors and courts”).

309. See Scott, *supra* note 5 and accompanying text. Cf. Bruner, *supra* note 57, *passim* (questioning whether duty of care should be considered a fiduciary duty).

310. See, e.g., CONAGLEN, *supra* note 160, at 39 (“[D]uties of care are not peculiar to fiduciaries and so do not merit consideration as ‘fiduciary’ duties.”); Miller, *supra* note 291, at 976 (“It is . . . unclear whether the duty of care . . . is a fiduciary duty.”).

311. See Velasco, *supra* note 23, at 1293 (“There is no great need for simplification . . . because the numbers at issue are relatively small . . . and certainly not beyond the ability of practicing attorneys and sitting judges.”).

312. See *supra* Part II.C.1.

313. See Rock, *supra* note 78, at 1017 (“[D]espite the fact-specific, narrative quality of Delaware opinions,

the courts were to recalibrate, it would eventually recur. Moreover, corporate managers actually welcome this.<sup>314</sup> Although there are many advantages to standards, they are by nature indeterminate and therefore somewhat risky. Corporate managers prefer the certainty of rules.<sup>315</sup> Whatever the standard may be, those who are subject to it will often want it concretized into specific rules.<sup>316</sup> Thus, attempting to get rid of the accretion of rules is somewhat futile.

Finally, although simplicity has its value, it should not come at the expense of the substantive law and the values it represents. What is needed is the level of complexity that is appropriate to the subject matter.<sup>317</sup> It might make sense to simplify highly technical rules of conduct that were intended to implement general standards, but it is less defensible to eliminate the underlying standards altogether. Thus, eliminating of the duty of care itself, and possibly reducing fiduciary duty to a rule against self-dealing, goes too far.

Properly understood, fiduciary duties cannot be simplified by eliminating the duty of care. Fiduciary law requires directors to pursue the interests of shareholders thoroughly.<sup>318</sup> The duty of care merely requires them to do so with diligence. Diligence is one of the most fundamental components of that duty, and one of the qualities that beneficiaries want most out of their fiduciaries.<sup>319</sup> Thus, it would be impossible to eliminate the duty of care and retain the broad conception of fiduciary duty. Doing so would not be a simplification of the law, but an oversimplification. It would amount to a reconceptualization of the fiduciary relationship.

### C. Doomed to Failure

I have argued that fiduciary duty is a broad concept that necessarily encompasses the duty of care, and that the elimination of the duty of care would amount to a reductionist oversimplification of the law. As my final claim, I submit that the urge to simplify—or oversimplify—fiduciary duties is ultimately doomed to failure. In the long run, courts sitting in equity, as the Delaware courts do, will be unable or unwilling to permit directors to ignore their fiduciary duties, broadly understood.

I start with the observation that courts like to develop tests that allow them a great

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over time they yield reasonably determinate guidelines.”). *But compare id.* at 1015 (“[T]he Delaware courts fill out the concept of ‘good faith’ through fact-intensive, normatively saturated descriptions of manager, director, and lawyer conduct, and of process—descriptions that are not reducible to rules[.]”).

314. *Cf.* Steele & Verret, *supra* note 276, at 209–10 (“[B]oards and deal lawyers . . . hope to structure negotiated deals that are advantageous to parties involved without running afoul of their fiduciary duties, yet face overwhelming uncertainty of the line that divides measures protected by the business judgment rule from those that violate fiduciary duties.”).

315. Of course, what they really want is the *right* rule. But, *ceteris paribus*, a rule might be preferable to a standard.

316. *Cf.* Rock, *supra* note 78, at 1014 (“There is a persistent tendency to acknowledge that Delaware corporate law largely involves standards, but then to try to reduce it to a set of rules.”).

317. *Cf.* Veasey & Di Guglielmo, *supra* note 13, at 1413 (“Fiduciary law is based on equitable principles. Thus, it is both inherently and usefully indeterminate, because it allows business practices and expectations to evolve, and enables courts to review compliance with those evolving practices and expectations.”); Allen et al., *supra* note 15, 1294 (“Given the blunt nature of the fiduciary doctrine tool, judges must instead describe fiduciary duties in general terms that can (it is hoped) be sensibly and fairly applied in future diverse circumstances in which directors are called upon to act.”).

318. *See supra* notes 298–300 and accompanying text (discussing pervasiveness of the duty of care).

319. *See supra* note 266 and accompanying text.

deal of flexibility. This flexibility is perhaps most evident in standards such as the entire fairness test and enhanced scrutiny.<sup>320</sup> However, my point is better illustrated by reference to the waste test.<sup>321</sup> The business judgment rule stands for the proposition that the courts will not review the substantive merits of business decisions.<sup>322</sup> In *Brehm v. Eisner*,<sup>323</sup> the Delaware Supreme Court made a very forceful statement to that effect:

As for the plaintiffs' contention that the directors failed to exercise "substantive due care," we should note that such a concept is foreign to the business judgment rule. Courts do not measure, weigh or quantify directors' judgments. We do not even decide if they are reasonable in this context. Due care in the decisionmaking context is *process* due care only.<sup>324</sup>

Scholars tend to agree that courts should not review the substance of business decisions absent some other breach of fiduciary duty.<sup>325</sup> This policy is so strong that many consider the business judgment rule to be a policy of non-review, rather than a standard of review.<sup>326</sup> As a standard of review, the waste test has been called "a theoretical exception," because it "has resulted in no awards of money damages against corporate officers or directors in Delaware[.]"<sup>327</sup> Nevertheless, courts seem to be unable to do away with the waste test.<sup>328</sup> Even as courts opine on the strength of the business judgment rule, they generally reserve the right to review the substance of business decisions. Thus, for example, the passage from *Brehm v. Eisner* quoted above continues as follows: "Irrationality is the outer limit of the business judgment rule. Irrationality may be the functional equivalent of the waste test or it may tend to show that the decision is not made in good faith, which is a key ingredient of the business judgment rule."<sup>329</sup>

It stands to reason that, if the courts cannot let go of review for substance, they will be even more hesitant concerning the decision-making process.

However, my claim does not rely on this intuition. The fact is that we have seen something that very closely resembles what I suggest can happen. I am speaking of the virtual elimination of the duty of care by the legislature and its subsequent revival by the courts.

Consider the following narrative: In *Smith v. Van Gorkom*,<sup>330</sup> the Delaware Supreme Court sought to breathe life into the duty of care. Apparently, it went too far, because legislatures responded by allowing the adoption of exculpation provisions.<sup>331</sup> Allowing the elimination of damages for duty of care claims eviscerated the duty of care. Rather than

320. See *Weinberger v. UOP, Inc.*, 457 A.2d 701, 711 (Del. 1983) (describing entire fairness test); *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954–57 (Del. 1985) (establishing enhanced scrutiny). Other notable examples would include the tests for piercing the corporate veil and corporate opportunities.

321. See generally 1 BLOCK ET AL., *supra* note 6, at 84–90, 93–97 (discussing the waste test); see also *Velasco*, *supra* note 23, at 1252–56 (same).

322. See *supra* notes 26–27, 96–97 and accompanying text.

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

324. *Brehm*, 746 A.2d at 264 (emphasis in the original); see *supra* note 74 and accompanying text.

325. See *supra* notes 74–75 and accompanying text.

326. See *supra* note 15 and accompanying text.

327. *Gagliardi v. Trifoods Int'l, Inc.*, 683 A.2d 1049, 1051–52 (Del. Ch. 1996). See *supra* note 27 and accompanying text.

328. See *supra* note 8 and accompanying text.

329. *Brehm*, 746 A.2d at 264.

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

331. See *supra* notes 19–20 and accompanying text.

being rare but theoretically possible, damages for breach of the duty of care became impossible. However, this situation would not last forever. Over time, the specter of the *Van Gorkom* decision receded, and the need for a duty of care grew. At the continual prodding of shareholder plaintiffs, the Delaware courts eventually relented and allowed duty of care claims to be recast as duty of good faith claims in *Disney* and *Stone v. Ritter*.<sup>332</sup> The significance of this development cannot be overstated: because good faith claims cannot be exculpated, damages based on carelessness became a possibility once more.

Of course, the Delaware courts would not agree with the foregoing narrative. They insist that gross negligence, which would be enough to establish a duty of care violation, is insufficient to establish a good faith violation.<sup>333</sup> Thus, the legislative decision to allow exculpation for care claims but not for good faith claims has been respected.<sup>334</sup> However, that response is not entirely satisfying.

The standard of review for duty of care claims was never entirely clear. It has been articulated in many different ways over the years.<sup>335</sup> It was only in 1984 that the Delaware Supreme Court settled upon the formulation of gross negligence.<sup>336</sup> Even so, the term gross negligence has been interpreted in many different ways. Some have interpreted it as synonymous with recklessness.<sup>337</sup> Thus, when the Delaware Supreme Court held that conscious disregard of one's duties, or recklessness, would be sufficient to establish a violation of the duty of good faith, it was arguably restoring Delaware law to (one plausible interpretation of) the pre-exculpation business judgment rule.

This view is buttressed by the Delaware Supreme Court's reliance on the *Caremark* opinion.<sup>338</sup> Although the *Stone* opinion interpreted *Caremark* as involving the duty of good faith, the case was clearly a duty of care case: "even the most cursory reading of *Caremark* demonstrates that Allen viewed oversight liability as a species of the duty of care . . ." <sup>339</sup> The case was decided as a care case, and the issue involved—monitoring—is a care issue. Indeed, at the time *Caremark* was decided, good faith was barely even on the judicial radar. Thus, the *Stone* court not only converted monitoring into a good faith issue, it also took the *Caremark* standard, which was intended as a duty of care standard<sup>340</sup>—an application of

332. *In re the Walt Disney Company Deriv. Litig.*, 906 A.2d 27 (2006); *Stone v. Ritter* 911 A.2d 362 (Del. 2006).

333. *Disney*, 906 A.2d at 65.

334. *See id.* ("[A] corporation can exculpate its directors from monetary liability for a breach of the duty of care, but not for conduct that is not in good faith. To adopt a definition of bad faith that would cause a violation of the duty of care automatically to become an act or omission 'not in good faith,' would eviscerate the protections accorded to directors by the General Assembly's adoption of Section 102(b)(7).")

335. *See, e.g.*, 1 AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 4.01(c) (2005) (stating the requirements for making a business judgment in good faith); 2 MODEL BUS. CORP. ACT § 8.31, official cmt., at 8-197 (2002) ("In basic principle, a board of directors enjoys a presumption of sound business judgment and its decisions will not be disturbed (by a court substituting its own notions of what is or is not sound business judgment) if they can be attributed to any rational business purpose.") (citation omitted). For additional formulations, see 1 KNEPPER & BAILEY, *supra* note 42, § 2.01, at 2-1 to -5 (providing various conceptions of the business judgment rule standard).

336. *See Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984) ("[U]nder the business judgment rule director liability is predicated upon concepts of gross negligence.")

337. *See, e.g.*, Allen et al., *supra* note 15, at 1300 ("[G]ross negligence . . . involves a devil-may-care attitude or indifference to duty amounting to recklessness.")

338. *In re Caremark Int'l, Inc. Deriv. Litig.*, 698 A.2d 959 (Del. Ch. 1996).

339. Bainbridge et al., *supra* note 200, at 595-96.

340. *See Caremark*, 698 A.2d at 968 ("[T]he core element of any corporate law duty of inquiry . . . [is]

the business judgment rule, as Chancellor Allen saw it<sup>341</sup>—and repurposed it as the standard for good faith.

When viewed in this light, the developments in *Stone* seem downright illegitimate.<sup>342</sup> Although the legislature had decided that care issues should be entirely exculpable, the Supreme Court decided that they could lead to liability after all. As a result, the attempt to eliminate the duty of care had ultimately failed.

I do not mean to suggest that the foregoing account is the correct way to interpret the events in *Stone*. The opinion can legitimately be understood to address the independent and non-exculpable issues of good faith and intentional misconduct.<sup>343</sup> Nevertheless, the narrative remains compelling. It suggests that attempts to restrict fiduciary duties may be doomed to failure.

Two final points are worth making. First, the Delaware courts' current understanding of the duty of good faith makes the status of the duty of care less important as a practical matter. Apparently, care-type issues survive in the guise of good faith. Second, care-type claims are not necessarily dependent upon the duty of good faith. The *Stone* court announced a broad conception of the duty of loyalty.<sup>344</sup> Similarly, Chief Justice Strine has forcefully advocated for a broad interpretation of the concept of loyalty.<sup>345</sup> Given that the concepts of care and loyalty are not as distinct as they may at first appear,<sup>346</sup> it would not be fanciful to imagine that the court could find other ways to inject care-type issues into the capacious duty of loyalty. The most obvious way would be to declare shirking to be a form of self-dealing.<sup>347</sup>

All of this is unfortunate. It does very little to simplify the law. To the contrary, it conflates the law and does so in ways that can seem illegitimate. Thus, the courts should avoid the urge to (over-)simplify the law of fiduciary duties and instead just try to get it right.

A broad understanding of fiduciary duty allows for the existence of multiple, but well-defined, fiduciary duties. Care would deal with diligence issues and would be afforded a great deal of (but not unlimited) deference. Loyalty would be confined to conflicts of interest, as it traditionally has been, and would be scrutinized closely. And good faith would be limited to those rare cases that involve intentional misconduct.<sup>348</sup> This is a much simpler

whether there was good faith effort to be informed and exercise judgment.”).

341. *See id.* at 967–68 (“[T]he business judgment rule is process oriented and informed by a deep respect for all *good faith* board decisions.”); *Gagliardi v. TriFoods Int’l, Inc.*, 683 A.2d 1049, 1051 (Del. Ch. 1996) (“I start with what I take to be an elementary precept of corporation law: in the absence of facts showing self-dealing or improper motive, a corporate officer or director is not legally responsible to the corporation for losses that may be suffered as a result of a decision that an officer made or that directors authorized in good faith.”).

342. *See Velasco, supra* note 23, at 1304 (“[T]he court converted a duty of care claim, which the legislature had determined should be exculpable, into a duty of loyalty issue, which is not.”).

343. *See id.* at 1304 (“If the failure to monitor reflects intentional misconduct, however, it also violates a duty of good faith and is not exculpable.”). This view depends upon the premise that the view that gross negligence amounts to recklessness is simply wrong.

344. *See Stone v. Ritter*, 911 A.2d 362, 370 (Del. 2006) (“[T]he fiduciary duty of loyalty is not limited to cases involving a financial or other cognizable fiduciary conflict of interest. It also encompasses cases where the fiduciary fails to act in good faith.”).

345. *See generally* Strine et. al, *supra* note 295.

346. *See supra* notes 268–269 and accompanying text.

347. *See id.*

348. In other work, I have argued that there are other fiduciary duties as well. *See generally* Velasco, *supra* note 23 (adding objectivity and rationality to care, loyalty, and good faith).

model than the alternative provided by *Stone*, where one can never be sure what is required by the capacious duty of loyalty. More importantly, it is a solid and stable model that respects the purpose of fiduciary duties in the first place.

#### V. CONCLUSION

In this Article, I have set forth a comprehensive defense of the fiduciary duty of care in corporate law. I have considered various arguments against the duty of care, as well as those in favor. With respect to the former, I concluded that the arguments support reduced enforcement of the duty of care, but not its elimination. With respect to the latter, I concluded that there are legitimate and important reasons to have a duty of care. Corporate law respects both sets of concerns by maintaining a duty of care that is deliberately underenforced, but not entirely unenforceable. I closed with an explanation of the wisdom and importance of this result.

My ultimate goal in writing this Article has been to create space for a meaningful duty of care in corporate law. The value of the duty of care need not come from strict legal enforcement—a fact that corporate law has long realized. However, the lack of enforcement should not render the duty of care meaningless, and it certainly does not render it unnecessary. Corporate law and fiduciary law both need the duty of care. They need fiduciaries to pursue the interests of the beneficiaries in all relevant respects, including with diligence. Thus, corporate law must tell managers that this is what the law requires and demands of them.