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DANGEROUS LIAISONS: CORPORATE LAW, TRUST LAW, AND INTERDOCTRINAL LEGAL TRANSPLANTS

Edward Rock & Michael Wachter***

People were shocked by *Smith v. Van Gorkom*.[1] Teeth were gnashed. The Delaware General Corporate Law ("GCL") was amended. The world went on.

But why were people so surprised and so upset? As we all know, corporate law emerged out of the law of trusts and agency. It had long been said that directors, like trustees and agents, have a duty of care. The trustee's duty of care had classically been elaborated in negligence terms, as a duty "to exercise such care and skill as a man of ordinary prudence would exercise in dealing with his own property."[2] When trustees act negligently, they are liable for the damages that they cause. Agents, too, are liable for negligence in the performance of their duties.[3] And, here, in *Smith v. Van Gorkom*, we had a case in which, at least in the eyes of the Delaware Supreme Court, directors acted with gross negligence. So liability was imposed. Why such a big deal?

One answer is that it had never happened before. Never before had Delaware directors been held liable for a breach of the duty of care absent a breach of the duty of loyalty, at least outside the context of financial institutions. But, as an explanation, that answer is incomplete. First, it does not explain *why* it had not happened before. Moreover, it does not explain whether finally having such a case, which brought with it the prospect of additional such cases, was good or bad for shareholders. Finally, it does not explain why this negligence-based fiduciary duty of care was and is a fixture of trust and agency law while it proves so troublesome in corporate law.

So what is going on? How is it that corporate law is drawn to talking about a director's duty of care as "the care that an ordinarily prudent person

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[1] 488 A.2d 858 (Del. 1985).

[2] RESTATEMENT OF TRUSTS § 174 (1935).

[3] *See, e.g.*, RESTATEMENT OF AGENCY §§ 379, 399, 401 (1933); FLOYD R. MECHEM, OUTLINES OF THE LAW OF AGENCY 360 (4th ed. 1952) (with citations).

would exercise under similar circumstances,"[4] yet, when courts finally take that talk seriously, the corporate world rebels? Why is corporate law's flirtation with negligence talk such a dangerous liaison? That is the question we address in this Article.

What is required is both an analysis and a diagnosis. We provide both. The duty of care is a "legal transplant": it is a fixture of the classical law of trusts and agency that was transplanted into corporate law along with the duty of loyalty. As is often the case with legal transplants, whether interdoctrinal or cross border, transplants can cause mischief.[5] When a legal concept is taken from one context and incorporated into a fundamentally different setting, it may carry with it implications and characteristics that do not serve anyone's interests. The logic of legal concepts has a momentum of its own.

The peculiar problems with corporate law's duty of care derive from the transplanting of a concept from the market context into the firm context. Difficulties arise if one fails to recognize the market–firm boundary as critical. That boundary represents a choice of governance structure, a choice between third-party judicial enforcement of market transactions and nonlegal self-governance within firms.

In moving unselfconsciously across this boundary, the seeds of mischief were sown. It is, indeed, evidence of corporate law's sensitivity to the underlying economic logic of firms that, through the device of the business judgment rule, it was able to keep the mischief at bay for so long. Eventually, however, the logic of legal concepts won out, and the court imposed liability for negligent director conduct.

The story has a happy ending. Shareholders, managers, and the Delaware legislature rode to the rescue, enacted section 102(b)(7),[6] and largely restored the status quo ante. But it is a cautionary tale nonetheless. Transplanting legal concepts, without attention to the underlying context, can cause great mischief.

I. THE MESS

An "ordinary prudence" or "reasonable person" duty of care, if taken seriously, creates an impossible mess for corporate law. To demonstrate this difficulty, this Part will first review the duties of loyalty and care that apply to trustees and agents and will then trace the problems created in the attempts to incorporate these duties into Delaware corporate law and the Model Business Corporation Act.

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[4] DENNIS J. BLOCK ET AL., THE BUSINESS JUDGMENT RULE: FIDUCIARY DUTIES OF CORPORATE DIRECTORS 52 (4th ed. Supp. 1994).

[5] ALAN WATSON, LEGAL TRANSPLANTS: AN APPROACH TO COMPARATIVE LAW (1974).

[6] DEL. CODE ANN. tit. 8, § 102(b)(7) (2000).

A. Short Primer on the Duty of Care in Trust and Agency Law

Trust law and agency law define the duties of the trustee and agent, respectively. The original Restatements provide the clearest view of the "classical" versions of these bodies of law. The first Restatement of Trusts, the reporter for which was the great trust scholar Austin W. Scott, provides a comprehensive articulation of the classical law of trusts.

Chapter 7, Topic 2, addresses the duties of the trustee. According to the Restatement, a trustee has the following duties: to administer the trust;[7] to act with loyalty to the beneficiaries;[8] not to delegate;[9] to keep and render accounts;[10] to furnish information;[11] to exercise reasonable care and skill;[12] to take and keep control;[13] to preserve trust property;[14] to enforce claims;[15] to defend actions;[16] to keep trust property separate;[17] to make the trust property productive;[18] to pay income to beneficiaries;[19] and to deal impartially with beneficiaries.[20] A trust relationship is a "fiduciary" relationship and the duties that arise out of it are "fiduciary" duties.[21]

The Trustee's duty of loyalty is "a duty to the beneficiary to administer the trust solely in the interest of the beneficiary."[22] If a trustee deals with the beneficiary for the trustee's own account, the trustee "is under a duty to the beneficiary to deal fairly with him and to communicate to him all material facts in connection with the transaction which the trustee knows or should know."[23]

The trustee is also under a duty to exercise reasonable care and skill. As set forth in section 174:

> The trustee is under a duty to the beneficiary in administering the trust to exercise such care and skill as a man of ordinary prudence would exercise in dealing with his own property; and if the trustee has greater skill than that of a man

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[7] RESTATEMENT OF TRUSTS § 169 (1935).
[8] *Id.* § 170.
[9] *Id.* § 171.
[10] *Id.* § 172.
[11] *Id.* § 173.
[12] *Id.* § 174.
[13] *Id.* § 175.
[14] *Id.* § 176.
[15] *Id.* § 177.
[16] *Id.* § 178.
[17] *Id.* § 179.
[18] *Id.* § 181.
[19] *Id.* § 182.
[20] *Id.* § 183.
[21] *Id.* § 2.
[22] *Id.* § 170(1).
[23] *Id.* § 170(2).

> of ordinary prudence, he is under a duty to exercise such skill as he has.[24]

The comment to section 174 notes that

> the standard of care and skill required of a trustee is the external standard of a man of ordinary prudence in dealing with his own property. A trustee is liable for a loss resulting from his failure to use the care and skill of a man of ordinary prudence, although he may have exercised all the care and skill of which he was capable. On the other hand, if the trustee has a greater degree of skill than that of an ordinary man, he is liable for a loss resulting from the failure to use such skill as he has.[25]

The liability implications of this duty of care are elaborated in section 205, entitled "Liability in Case of Breach of Trust":

> If the trustee commits a breach of trust, he is chargeable with
>
> (a) any loss or depreciation in value of the trust estate resulting from the breach of trust; or
>
> (b) any profit made by him through the breach of trust; or
>
> (c) any profit which would have accrued to the trust estate if there had been no breach of trust.[26]

The comments to section 205 make clear that a trustee is liable for loss to the trust estate from his negligence in dealing with trust property. Thus, in illustration 1, "A is trustee of $10,000 in cash. As a result of his negligence the money is stolen. A is liable for $10,000."[27] Similarly, in illustration 4,

> A is trustee of a mortgage for $10,000. When the mortgage matures, A negligently fails to foreclose the mortgage, although it is evident that the value of the property is only slightly in excess of the amount of the mortgage and owing to a change in the character of the neighborhood is likely to depreciate. A subsequently forecloses the mortgage and the land is sold for $6000. A is liable for $4000.[28]

Numerous other illustrations are to like effect.

Section 206 applies the rule of section 205 to breaches of the duty of loyalty. Under section 206, if a trustee

> commits a breach of his duty of loyalty he is chargeable with any loss or depreciation in value of the trust property resulting from the breach of duty, or any profit made by him through the breach of duty, or any profit which would have accrued to the trust estate if there had been no breach of duty.[29]

The overall structure is clear. Trustees are charged with duties, includ-

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[24] *Id.* § 174.

[25] *Id.* § 174 cmt. (a).

[26] *Id.* § 205.

[27] *Id.* § 205 illus. 1.

[28] *Id.* § 205 illus. 4.

[29] *Id.* § 206 cmt. (a).

ing a duty of loyalty and a duty of care. The duty of care is a duty to "exercise such care and skill as a man of ordinary prudence would exercise in dealing with his own property."[30] If a trustee breaches either duty, through self-dealing or through negligence, the trustee is liable to the trust estate for any losses or foregone gains. These duties, moreover, are enforced in equity.

One finds a very similar development in the law of agency. The Restatement of Agency provides that

> [u]nless otherwise agreed, a paid agent is subject to a duty to the principal to act with standard care and with the skill which is standard in the locality for the kind of work which he is employed to perform and, in addition, to exercise any special skill that he has.[31]

The Restatement explicitly recognized this as imposing a negligence standard.[32] When the agent is a trustee, liability follows the law of trusts, described earlier. When the agency is based on contract, liability follows contract law. Otherwise, liability sounds in tort:

> In accordance with the principles stated in the Restatement of Torts, an agent is subject to liability for loss caused to the principal by any breach of duty except a breach of duty arising wholly from a contract with the principal.[33]

The Restatement (Second) of Agency is to like effect.[34]

B. Transplanting Fiduciary Duties

As is well known, corporate law emerged out of common-law trust and agency. Prior to 1844, when England first freely allowed incorporation by registration (as opposed to special legislative act or charter), "most joint stock companies were unincorporated and depended for their validity on a deed of settlement vesting the property of the company in trustees."[35] The trust form of business enterprise assumed prominence in the latter part of the Nineteenth Century as well, when trusts were used to avoid state corporate law limitations on the scope of interstate enterprises.[36] That trust and agency law should provide part of the conceptual foundation of corporate law is not surprising: corporations often involve the management of assets by one person for the benefit of another.

One thus finds trust and agency concepts playing prominent roles in

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[30] *Id.* § 174.

[31] RESTATEMENT OF AGENCY § 379(1) (1933).

[32] *Id.* § 379 cmt. (c).

[33] *Id.* at § 401.

[34] *See* RESTATEMENT (SECOND) OF AGENCY §§ 379, 399, 401 (1958).

[35] PAUL L. DAVIES, GOWER'S PRINCIPLES OF MODERN COMPANY LAW 598 (6th ed. 1997). See Chapters 2 and 3 for a very useful and concise summary of the history of corporate law, with useful citations.

[36] *See* HERBERT HOVENKAMP, ENTERPRISE AND AMERICAN LAW 1836-1937, at 241-67 (1991).

corporate law cases. For example, in the famous 1742 English case, *Charitable Corp. v. Sutton*,[37] the court drew on trust and agency law to impose liability on the directors of a charitable corporation who failed to monitor loans made to fellow directors. The court held that "[b]y accepting of a trust of this sort, a person is obliged to execute it with fidelity and reasonable diligence."[38]

One finds similar statements in United States cases from the Nineteenth Century. *Briggs v. Spaulding*,[39] a bank case, is cited for the proposition that directors should be held to the action of "ordinarily prudent and diligent men." In the twentieth century, this tendency to attribute "fiduciary duties" to directors of financial institutions was apparently extended to industrial concerns.[40] In *Litwin v. Allen*,[41] the famous New York case involving the Morgan bank and the Van Sweringen group, the court articulated a director's duties as follows:

> It has sometimes been said that directors are trustees. If this means that directors in the performance of their duties stand in a fiduciary relationship to the company, that statement is essentially correct. The directors are bound by all those rules of conscientious fairness, morality, and honesty in purpose which the law imposes as the guides for those who are under the fiduciary obligations and responsibilities. They are held, in official action, to the extreme measure of candor, unselfishness, and good faith. Those principles are rigid, essential, and salutary.[42]

This much is drawn directly from classical trust and agency law. The court then expanded on the content of this duty of loyalty in the corporate context:

> It is clear that a director owes loyalty and allegiance to the company—a loyalty that is undivided and an allegiance that is influenced in action by no consideration other than the welfare of the corporation. Any adverse interest of a director will be subjected to a scrutiny rigid and uncompromising. He may not profit at the expense of his corporation and in conflict with its rights; he may not for personal gain divert unto himself the opportunities which in equity and fairness belong to his corporation. He is required to use his independent judgment.[43]

This tracks closely the trustee's duty of loyalty (compare to Restatement section 170). The court then continued, focusing on a duty of care:

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[37] 2 Atk. 400, 26 Eng. Rep. 642 (Ch. 1742).

[38] 2 Atk. at 406, 26 Eng. Rep. at 645.

[39] 141 U.S. 132 (1891).

[40] Henry Ridgely Horsey, *The Duty of Care Component of the Delaware Business Judgment Rule*, 19 DEL. J. CORP. L. 971, 974 (1994).

[41] 25 N.Y.S.2d 667 (N.Y. Sup. Ct. 1940).

[42] *Id.* at 677 (citations omitted).

[43] *Id.*

> In the discharge of his duties a director must, of course, act honestly and in good faith, but that is not enough. He must also exercise some degree of skill and prudence and diligence. . . . In other words, directors are liable for negligence in the performance of their duties. Not being insurers, directors are not liable for errors of judgment or for mistakes while acting with reasonable skill and prudence. It has been said that a director is required to conduct the business of the corporation with the same degree of fidelity and care as an ordinarily prudent man would exercise in the management of his own affairs of like magnitude and importance. General rules, however, are not altogether helpful. In the last analysis, whether or not a director has discharged his duty, whether or not he has been negligent, depends upon the facts and circumstances of a particular case, the kind of corporation involved, its size and financial resources, the magnitude of the transaction, and the immediacy of the problem presented. A director is called upon "to bestow the care and skill" which the situation demands.[44]

Here, not coincidentally, we see the duty of care articulated in terms very similar to those of the Restatement of Trusts. Both use the phrase "ordinarily prudent man would exercise in the management of his own affairs."

C. The Evolution of the Duty of Care in Delaware

But now a bit of a puzzle emerges. Trust law establishes a coherent scheme of duties enforced by a liability regime. When a trustee negligently performs his duty of care, he can be held liable to the trust estate. And, moreover, this apparently happens in a nontrivial number of cases. Agency law reflects a similar structure, although somewhat complicated by the overlaps between agency law and trust law (when the agent is a trustee) and between agency law and contract law (when the agent and principal have entered into a contract which the agent is said to breach).

Although the trustee's duty of care seems to have been carried over into corporate law, it has long been noted that there are vanishingly few cases of liability.[45] Moreover, the situation is even more extreme in the leading corporate jurisdiction, Delaware, where even the articulation of a duty of care seems to have been late and grudging.

In an important article tracing the development of the duty of care in Delaware, Justice Horsey argues that while there may have been earlier anticipations, it was not until the 1963 decision of *Graham v. Allis-Chalmers Manufacturing*[46] that Delaware articulated a director's duty of care.[47] Until

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[44] *Id.* at 677-78 (citations omitted).

[45] Joseph W. Bishop, Jr., *Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers*, 77 YALE L.J. 1078 (1968); 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); Richard B. Dyson, *The Director's Liablity for Negligence*, 40 IND. L. REV. 341 (1965).

[46] 188 A.2d 125 (Del. 1963).

[47] Horsey, *supra* note 40, at 982-83.

then, the courts had focused on fraud, actual or constructive. The critical part of the *Graham* opinion, in Horsey's view, is when the court stated that "it appears that 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."[48] In *Graham*, of course, the court held that the directors had not breached their duty of care.

In three cases in the early 1970s, the court of chancery recognized an enforceable directorial duty of care.[49] In none of these cases was liability imposed on directors. In *Kaplan*, the only liability imposed involved a third party and was based on a contractual claim.[50] In *Penn Mart*, a motion to dismiss was denied.[51] In *Gimbel*, an injunction was issued with a very large bond required.[52]

These developments helped form the basis for the next key Delaware Supreme Court case on the duty of care, namely, *Aronson v. Lewis*.[53] There, the court stated that

> to invoke the [business judgment] rule's protection directors have a duty to inform themselves, prior to making a business decision, of all material information reasonably available to them. Having become so informed, they must then act with requisite care in the discharge of their duties. While the Delaware cases use a variety of terms to describe the applicable standard of care, our analysis satisfies us that under the business judgment rule director liability is predicated upon concepts of gross negligence.[54]

Leaving aside the confusion that the *Aronson* court introduced by merging its discussion of the duty of care and the business judgment rule,[55] what is most important about *Aronson*, for our purposes, is the extent to which it ties both the duty of care and the applicability of the business judgment rule to a negligence (or "gross negligence") standard.[56]

Aronson, itself, was a somewhat odd context for the elaboration of the duty of care and directorial liability. In *Aronson*, the key question was the standard for determining whether a derivative suit should be dismissed for failure to make a demand on the board. The Delaware Supreme Court

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48 *Graham*, 188 A.2d at 130.

49 Gimbel v. Signal Cos., 316 A.2d 619 (Del. 1974); Penn Mart Realty Co. v. Becker, 298 A.2d 349 (Del. Ch. 1972); Kaplan v. Centex Corp., 284 A.2d 119 (Del. Ch. 1971). In *Penn Mart Realty*, this duty was explicitly based on trust law. *Penn Mart*, 298 A.2d at 351 (citing, inter alia, GEORGE G. BOGERT, TRUSTS AND TRUSTEES, § 901 (1977)).

50 *Kaplan*, 284 A.2d at 125-39.

51 *Penn Mart*, 298 A.2d at 352.

52 *Gimbel*, 316 A.2d at 618.

53 473 A.2d 805 (Del. 1984).

54 *Id.* at 812.

55 For a perceptive critique of Delaware case law from this perspective, see Lyman Johnson, *Rethinking Judicial Review of Director Care*, 24 DEL. J. CORP. L. 787 (1999).

56 It has long been debated whether there is a difference between "negligence" and "gross negligence."

viewed the question of demand as intimately related to the scope of directors' business judgment because the decision whether to bring suit on behalf of the firm, like many other decision, is, in the first instance, for the board. This relationship led the court to analyze the question whether demand was required or futile in terms of whether the business judgment rule applied. In the context of discussing when the business judgment rule applied (and thus when demand was required by a derivative plaintiff), the court inserted the negligence concepts of *Graham*, *Kaplan*, and *Penn Mart* into the business judgment rule itself. *Aronson*, then, without imposing any liability on any director, expressed the Delaware Supreme Court's understanding that directors would be liable for gross negligence, despite the business judgment rule.

The *Aronson* decision set the stage for *Smith v. Van Gorkom*, the subject of this Symposium. Finally, in *Van Gorkom*, decades or centuries after corporate law had become accustomed to talking about directors having a duty of care, a duty to act with the care that ordinarily prudent men would use, the Delaware courts imposed liability for the breach of that duty. On the supreme court's retelling of the facts, the directors were grossly negligent in selling the company, thereby breaching the duty of care and beyond any protection of the business judgment rule. The case was then remanded to the chancery court which was instructed to determine the "fair value" of the Trans Union shares and, thereafter, to award damages to the extent that the fair value of the shares exceeded the fifty-five dollars per share that shareholders received.

Finally, after all these years, there was a case in which the director's duty of care actually seemed to count for something. Perhaps Delaware was excessively tardy in finally enforcing a duty of care, but better late than never. What trust law has done routinely for years, Delaware finally got around to in 1985.

But there was one problem. The victory, if that is what it was, was short lived. In the wake of *Smith v. Van Gorkom*, a directors and officers (D&O) liability insurance crisis was triggered. Policies were not renewed, premiums skyrocketed, and firms worried about being able to recruit high quality directors.[57] In response, on June 18, 1986, a year and a half after the decision, the Delaware legislature enacted section 102(b)(7)[58] which permits firms to amend their certificates of incorporation to opt out of monetary liability for nonintentional breaches of the duty of care.

In the wake of section 102(b)(7), Delaware corporations quickly amended their certificates of incorporation, and thereby immunized directors from liability under *Van Gorkom*. These amendments were overwhelmingly

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[57] *See, e.g.*, H. Lee Murphy, *Firms Fortifying Board Defenses*, CRAIN'S CHI. BUS., Apr. 20, 1987, at 1, *available at* 1987 WL 2312455; Frederick D. Lipman, *Directors' Liabilities: Legislature Lends a Helping Hand*, FOCUS (PA.), May 13, 1987, at 78, *available at* 1987 WL 2321149.

[58] DEL. CODE ANN. tit. 8, § 102(b)(7) (2000).

approved by shareholders 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.

In sum, what one observes in Delaware corporate law, as in the corporate common law in other jurisdictions, is an attraction to a trustee like duty of care. This attraction is entirely natural. After all, the trustee's duty of loyalty was carried over into corporate law almost entirely intact. Why not incorporate the trustee's duty of care as well? Yet, when Delaware belatedly did so, directors, managers and shareholders alike rebelled.

D. The Evolution of the Duty of Care in the Model Business Corporation Act

One can observe a similar process of attraction and repulsion in the evolution of the duty of care under the Model Business Corporation Act ("MBCA"), and its interaction with the liability provisions. Because the MBCA is more self-conscious and discursive in its development than Delaware common law, one can more easily perceive the inherent tensions. Moreover, because the MBCA is much more "code like" than Delaware corporate law, the drafters were directly confronted with the question of what sort of standard of care should apply to directors. The key problem confronting the MBCA, as discussed in more detail below, was that the drafters wanted a "duty of care" very much like the trustee's "duty of care" but could not agree on the extent to which directors and officers should be liable for breaching that duty.

In a marvelous article celebrating the fiftieth anniversary of the Model Business Corporation Act, Franklin Balotti and Joseph Hinsey, long-time members of the MBCA drafting committee (the Committee on Corporate Laws of the American Bar Association), reviewed the tortured history of the MBCA's attempt to draft a duty of care.[59] Their story begins with the 1974 Amendment, which, for the first time, added an explicit duty of care. This was accomplished by amending Section 35 (the section giving the board the authority to oversee and direct the business and affairs of the corporation) to include an affirmative duty of care. It provided that

> [a] director shall perform his duties as a director, including his duties as a member of any committee of the board upon which he may serve, in good faith, in a manner he reasonably believes to be in the best interests of the cor-

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[59] R. Franklin Balotti & Joseph Hinsey IV, *Director Care, Conduct and Liability: The Model Business Corporation Act Solution*, 56 BUS. LAW. 35 (2000).

> poration, and with such care as an ordinarily prudent person in a like position would use under similar circumstances. In performing his duties, a director shall be entitled to rely on . . . [various data prepared or presented by various persons] . . . . A person who so performs his duties shall have no liability by reason of being or having been a director of the corporation.[60]

By incorporating a classic trust law "duty of care," a duty which in trust law is enforced through injunctions and damages, the amendment presented the question of the relationship between the duty of care and the business judgment rule, or, equivalently, the question of the extent of liability for breaching the duty of care. The 1974 comment to the amendment largely ignored these questions, other than to state that section 35's standard "reflects the good faith concept embodied in the so-called 'business judgment rule,' which has been viewed by the courts as a fundamental precept for many decades."[61] This comment is, in Balotti and Hinsey's words, "inscrutable."[62]

From 1980 to 1983, as part of the effort to develop a revised MBCA, the Committee continued to work on revising section 35. The Committee considered various formulations that would strike the appropriate balance between establishing a standard of care but not imposing undue liability on directors.[63] The goal seems to have been to draft the relevant section so that the standard of conduct, liability, and review would be set in a way that codified or, even better, superceded the business judgment rule.

The Committee's attempt faced extensive criticism,[64] the changes were abandoned, and the original provisions of section 35 were left largely intact (with the numbering changed to 8.30). Abandoning any attempt to codify (or clarify) the business judgment rule, the Official Comment made clear it was leaving the status quo, whatever that might be:

> The elements of the business judgment rule and the circumstances for its application are continuing to be developed by the courts. In view of that continuing judicial development, section 8.30 does not try to codify the business judgment rule or delineate the differences, if any, between that rule and the standards of director conduct set forth in this section. That is a task left to the courts and possibly to later revisions of the Model Act.[65]

Although the comment made clear that the section was not intended to displace the business judgment rule, it did not solve the difficulties created by the articulation of the standard of care because comments are not enacted

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[60] *Report of Committee on Corporate Laws: Changes in the Model Business Corporation Act*, 30 BUS. LAW. 501, 502 (1975), *quoted in* Balotti & Hinsey, *supra* note 59, at 40.

[61] *Id.* at 504.

[62] Balotti & Hinsey, *supra* note 59, at 41.

[63] *Id.* at 42-45.

[64] *Id.*

[65] MODEL BUS. CORP. ACT ANN. § 8.30 Official Commentary at 8-160 (3d ed. 1997), *quoted in* Balotti & Hinsey, *supra* note 59, at 46.

by the legislatures that adopt the MBCA. Thus, the concerns raised about the introduction of "tort-sounding concepts" and the resulting threat of liability remained, as did the confusion over the relationship between the duty of care and the business judgment rule.[66]

The Committee returned to the problem during the 1990s. This time, the Committee sought to distinguish explicitly between "standards of conduct" and "standards of liability," adopting Mel Eisenberg's analysis.[67] In doing so, the MBCA makes clear that the standards of conduct are designed to inform directors of their duties, while the standards of liability are designed to guide judges in the imposition of liability. The standard of conduct is a familiar, objective standard that contains traces of the original trustee duty of care:

> The members of the board of directors or a committee of the board, when becoming informed in connection with their decision-making function or devoting attention to their oversight function, shall discharge their duties with the care that a person in a like position would reasonably believe appropriate under similar circumstances.[68]

By contrast, section 8.31 makes clear that a breach of section 8.30 is not sufficient to establish liability. First, there is no liability if the certificate of incorporation includes an exculpatory provision authorized by section 2.02(b)(4), which is largely identical to section 102(b)(7) of the Delaware statute. In addition, even in the absence of such an exculpatory provision, director liability only attaches if

> [t]he challenged conduct consisted or was the result of: (i) action not in good faith or (ii) a decision (A) which the director did not reasonably believe to be in the best interest of the corporation, or (B) as to which the director was not informed to an extent the director reasonably believed appropriate in the circumstances.[69]

The MBCA expressly disclaims any codification of the business judgment rule. On the other hand, section 8.31 contains most or all of its elements. In doing so, the committee sought to hold the business judgment rule in reserve in case it was necessary to shield directors from liability independent of the statute.

By relying on a distinction between standards of conduct and standards of liability—a distinction entirely absent from classical trust law—the MBCA is able to arrive at more or less the same place as Delaware law. The "duty of care" in both cases has become—and, indeed, always was—largely a matter of exhortation, aspiration and nonlegal enforcement. Dela-

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[66] Balotti & Hinsey, *supra* note 59, at 47.

[67] *Id.* at 48 (citing Melvin Aron Eisenberg, *The Divergence of Standards of Conduct and Standards of Review in Corporate Law*, 62 FORDHAM L. REV. 437 (1993)).

[68] MODEL BUS. CORP. ACT ANN. § 8.30 (b).

[69] *Id.* § 8.31(a)(2).

Delaware traditionally achieved this through the business judgment rule and then supplemented it with section 102(b)(7) after *Smith v. Van Gorkom* upset the balance. The MBCA achieves this result by placing the duty of care in section 8.30 and then making explicit in section 8.31 that a breach of section 8.30 is necessary but not sufficient for liability.

II. SOURCES OF THE CONFUSION

A. The Primary Diagnosis

From a legal–doctrinal perspective, this is a somewhat odd and counterintuitive outcome. Review now the progression. In the classical law of trusts and agency, two important conceptual and doctrinal sources for corporate law, the trustee and agent both have a duty of loyalty and a duty of care. In trust law, the duty of care is articulated in terms of a duty to "exercise such care and skill as a man of ordinary prudence would exercise in dealing with his own property."[70] In agency law, it is articulated in terms of the "standard care and with the skill which is standard in the locality for the kind of work which he is employed to perform."[71] If a trustee or agent breaches either duty, either through self dealing or through negligence, the trustee or agent is liable for any losses or foregone gains.

These fiduciary duties were transplanted into corporate law. Unlike the legal transplants from Roman law that Alan Watson focuses on in his classic treatment,[72] these are what one might call "interdoctrinal legal transplants," namely, transplants from one doctrinal area to another, within the same national system. But the theoretical and practical problems presented are the same: as is often the case with legal transplants, the fit is imperfect because the contexts are different.

In corporate law, from the beginning, one can discern discomfort with the implications of the trust–agency model. The emergence of a common-law business judgment rule that shields directors from liability for negligent decisions—which, under trust and agency law, would clearly give rise to liability—was an adaptive response to the strong sense that we really do not want to hold directors to the same standards that we impose on trustees. The near universal rejection of the "rule" of *Smith v. Van Gorkom* through the enactment of, and amendments in accordance with, section 102(b)(7) is merely the latest and most recent expression of this discomfort. The controversy over the MBCA amendments and the ultimate outcome reflects similar concerns.

But why not? Why is a trust–agency law duty of care so inappropriate in the corporate context? Why did corporate law ultimately reject the transplant? What is the source of the problem?

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[70] RESTATEMENT OF TRUSTS § 174 (1935).

[71] RESTATEMENT OF AGENCY § 379(1) (1933).

[72] WATSON, *supra* note 5.

The answer is not found in the doctrinal logic, but in the economic foundations. With the development of the economic theory of the firm, we are now in a position to understand why transplanting a duty of care from the trust context to the internal corporate context is so deeply problematic. It is because the transplant is across the boundary between markets and firms, a boundary we now know is fundamental.

The paradigmatic trust relationship is, at its core, a market relationship: a settlor enters into a relationship with a trustee to manage trust property for the benefit of a beneficiary. The relationship is well defined, circumscribed by time and scope, and involves relatively few transactions often involving financial assets that can be sold in liquid markets. Thus, for example, a settlor might establish a trust for designated beneficiaries and, to protect the beneficiary, limit investments to government bonds.[73] In this low transaction cost setting, the settlor and the trustee can protect themselves by contract.

Because the settlor will often not be around during the performance by the trustee, and the beneficiary is often unable to or disabled from enforcing the terms, the law plays a crucial role in the establishment of trusts, and the enforcement of a trustee's duties. The sticky problems tend to arise after the settlor has passed from the scene. For example, it may be that because of unanticipated inflation, government bonds cease to be the most appropriate investment for achieving the settlor's objectives. The trustee may need additional flexibility, but without the ability to renegotiate, the trustee can only gain the needed reformation by appealing to the court or attempting to secure the unanimous approval of the beneficiaries.[74] This rigid structure works only to the extent that change is relatively slow and predictable and a court can easily provide the needed flexibility.

The classical paradigmatic agency relationship is likewise market based. A homeowner retains a real estate agent to market and sell a house. A customer retains a broker to buy and sell securities.

In the same way a client contracts with a lawyer for legal services, a settlor or principal can be understood as contracting for trustee or agency services. As in the case of the lawyer, when the services provided by the trustee or agent fall below the appropriate standard—when the trustee or agent is negligent—liability is often imposed. This explains why one should not be surprised to find that trustee or agent "malpractice" is handled through the same set of fundamental legal concepts and tools as professional malpractice. These are all market relations founded in the first instance on legally enforceable contracts and relationships.

But when transactions are brought within a firm, everything changes.[75]

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[73] *See, e.g.*, *In re* The Barnes Found., 683 A.2d 894 (Pa. Super. Ct. 1996).

[74] *See, e.g.*, *id.*

[75] For an extensive analysis of these points, see Edward B. Rock & Michael L. Wachter, *Islands of Conscious Power: Law, Norms and the Self Governing Corporation*, 149 U. PA. L. REV. 1619 (2001).

To see why, start with a prior question: why is it that transactions are brought within firms when there are markets? Why do some transactions occur through markets while others occur within firms? What explains the decision to make something rather than buy it? What determines the boundary between firms and markets?

Markets are great when they work. In markets involving many buyers and sellers, whether involving inputs or outputs, the market price is the most reliable indicator of costs. When a transaction involves such inputs or outputs, a contract can be agreed upon which will reliably price expenses and revenues. Moreover, the market functions as its own command structure. Supplies can be ordered, sales can be booked, and assets can be bought or sold. The market, by providing high-powered incentives to its participants, delivers performance. The courts, by providing remedies for breach that are based on market valuations of inputs and outputs, lend additional incentives for the parties to deliver performance. When performance comes up short in a way that breaches a contract, the court steps in to provide remedies and penalties. Judicial success in providing adequate relief, however, is dependent on the market supplying correct and adequate opportunity cost data. Markets work best when participants can rely on the law of contracts and judicial enforcement of contract works best when it can rely on market valuations.

But what about when you cannot write such contracts? This occurs in a variety of circumstances. When inputs or outputs are specific to a transaction, when the number of transactions involving these specific inputs or outputs becomes large and complex, or when activities are complex and interrelated, the market mechanism begins to fail. Absent sufficient numbers of buyers and sellers, valuations become less dependable. The more numerous, interrelated, and complex the specific transactions, the more costly is the writing of contracts. In these situations, the market can only deliver performance, and the courts can only assist performance at high cost.

As pointed out by the theorists of the firm—Coase, Williamson, Hart and others—when costs are high enough, transactions are brought inside the firm. For transactions inside the firm, the firm's authority structure replaces the market's command structure. Employees are hired and assigned to work with physical and intangible capital, intermediate goods are processed into finished goods, and decisions are made for the intended sale or purchase of assets through reliance on the authority of the firm's various decision makers. If sales decline or increase, inventory and capital are either idled or activated by executive decision and not by contract agreement among the affected parties. If employees, from executive officers to production workers, ignore orders or under perform, they are demoted, discharged, or otherwise penalized.

Intrafirm governance differs fundamentally from market governance. When contracting through markets, judicial enforcement of contracts provides a key governance structure. But when costs are too high for contracts

and markets, leading to transactions being brought within the firm, how is the intrafirm governance structure enforced? The answer is the familiar story from the incentive compatible contracting literature. Governance arrangements are self-enforcing when one party cannot act opportunistically by shifting the distribution of compensation ex post because doing so is self-defeating. This is accomplished by embedding self-activating penalties whenever the bad agent acts opportunistically. When these are not available or for extra protection, the arrangements also allow for self-help. The high transaction costs that bring certain transactions inside the boundary of firms also create the ideal grounds for developing governance arrangements that are self-enforcing, encouraging good play and discouraging opportunistic play. For these governance arrangements to function properly, the ability to punish opportunistic play is important, and the high-frequency, long-duration interactions among the parties operating together inside the firm allows ample opportunity to sanction bad play and encourage good play. Similarly, frequent transacting also generates a high return for investing in a good reputation.

The corporate relationship is thus at the opposite pole from the trust or agency relationship—open ended in time and scope, transactionally intensive, and often involving physical assets that are illiquid and difficult to value. The corporate director thus needs more flexibility to deal with evolving events than does the trustee. As trust litigation shows, using courts to provide flexibility is marginal, at best, in the trust context. In the corporate context, it is a nonstarter.

Bringing relationships into the firm should thus be understood as a choice between governance structures. When the market is chosen, contracting is mostly complete, and judges are expected to (and do) enforce those contracts, including filling in the small gaps that remain. That is what makes contracts so valuable when they can be written. But when contracting is sufficiently incomplete that relationships are brought inside the firm, the anticipated enforcement is nonjudicial: either self-enforcement or enforcement through nonlegal means. In such circumstances, the role of the judge is "forbearance," to leave the parties to work it out themselves. From this perspective, the boundary of the firm is a jurisdictional boundary chosen by the participants.

In corporate law, the integrity of this jurisdictional boundary has traditionally been protected by the business judgment rule. Just as in the nonunion employment relationship, where the employment-at-will doctrine protects the relationship from judicial interference, so, in corporate law, the business judgment rule has been the traditional doctrinal device for stopping judicial inquiry at the boundaries of the firm. The long history of coexistence between an articulated "duty of care" and no cases finding liability reflects the success of the business judgment rule in playing this jurisdictional role.

Now we can see why *Van Gorkom* was such a problematic opinion. In

the evolution of the duty of care and business judgment rule in Delaware from *Graham* through *Van Gorkom*, the two were merged, with the ultimate result being that the application of the business judgment rule depended on the directors not acting with "gross negligence." Thus, in *Van Gorkom*, where the directors were (according to the court) grossly negligent, they were not protected by the business judgment rule and thus liable for the difference between what the shareholders received and the fair value of the shares.

But making the boundary of judicial review depend on whether or not negligence is present is to ignore the imperatives of the firm–market boundary. Put simply, a key reason relationships are brought within firms is that the distribution of information is such that third parties cannot reliably determine whether parties behaved negligently or not. If the distribution of information had been otherwise, the relationship would have been left to the market.

To rest liability on the presence or absence of negligence when judges cannot reliably distinguish between negligent and non-negligent behavior causes a host of problems. First, decisions by the central managers of firms often mean that someone is disappointed. If that someone can either reverse the decision by appeal to an outside party, or use the appeal to an outside party to impose costs on other insiders, the internal balance will be upset. In addition, courts with inferior information will do systematically worse than the internal governance mechanism in adjudicating the merits of a dispute. Even worse, by allowing disappointed parties to appeal outside, the structure that forces the parties to work out their differences internally is impaired.

Consider *Smith v. Van Gorkom* in this context. Who were the disappointed people who appealed to an outside party? In the litigation context, these were the shareholders or their representatives. Before that, the most vocal opponents to the sale were the managers who, unlike the retiring Van Gorkom, very much wanted to remain with the firm and did not want it sold to an outsider. According to the court, "[t]he public announcement of the Pritzker merger resulted in an 'en masse' revolt of Trans Union's Senior Management."[76] The court incorrectly appeared to view this as one of the factors indicating that Van Gorkom had acted wrongfully.

But possibly even worse than the inaccuracy and imbalance caused by selective judicial interference is the elimination of a valuable legal form. If the choice of bringing relationships within the firm just is the choice of a governance mechanism, then selective intervention by the courts at the behest of a disappointed party will undermine that choice. No longer will parties be able to opt for the nonlegally enforced governance system that the firm offers by bringing relationships into the firm. Instead, parties will either have to duplicate the self-governance by contracts explicitly prohibit-

[76] Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985).

ing judicial intervention (if such contracts would be enforceable), or bear the additional costs of not being able to adopt the optimal organizational form.[77]

We are now in a position to understand why the trust–agency law duty of care transplant was and had to be rejected by corporate law. Once the duty of care crossed the firm–market boundary, it moved into the domain of nonjudicial enforcement. The business judgment rule emerged to block the judicial enforcement that accompanied the duty of care in trust and agency law. The section 102(b)(7) response to *Smith v. Van Gorkom*'s innovation largely preserved the choice of governance mechanism. The MBCA, after flirting with what looked like a judicially enforced duty of care, was forced by pressure from the corporate law community to back away. It finally made clear that enforcement of the duty of care was to be left to intrafirm devices and not placed in the hands of judges.

B. Why Was the Transplant of the Duty of Loyalty More Successful?

But, one might note, both the duty of care *and* the duty of loyalty were transplanted from trust and agency law. Why did a judicially enforced duty of loyalty take root, while a judicially enforced duty of care did not? Isn't a transplant of the duty of loyalty across the firm–market boundary equally problematic?

The duty of loyalty is critical to both trust and agency law. By prohibiting the trustee or agent from stealing from the beneficiary or principal, the duty of loyalty makes possible these relationships in which the settlor or principal gives up control, and, moreover, helps align the interests of the trustee or agent with the interests of the beneficiary or principal. In the corporate context, the duty of loyalty serves the same purpose.

Unlike the duty of care that remained largely untested for decades, the duty of loyalty was tested early in the corporate context.[78] Strikingly, in crossing the market–firm boundary, the duty of loyalty evolved away from its trust law origins. The doctrinal evolution of the duty of loyalty in corporation law, from a flat prohibition against self-dealing (that is, the pure trust law duty of loyalty) towards a more flexible standard allowing for self-dealing in some circumstances, is chronicled in a well-known article by Harold Marsh.[79] Although Marsh's main contention has been generally accepted, there is little agreement as to why the transition occurred.[80]

The doctrinal analysis took advantage of flexibility in trust law: al-

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[77] For a fuller analysis, see Edward R. Rock & Michael L. Wachter, *The Enforceability of Norms and the Employment Relationship*, 144 U. PA. L. REV. 1913 (1996).

[78] For a survey of the early cases, see Harold Marsh, *Are Directors Trustees? Conflicts of Interest and Corporate Morality*, 22 BUS. LAW. 35 (1960).

[79] *Id.*

[80] ROBERT CHARLES CLARK, CORPORATE LAW 161-62 (1986).

though the trustee could not deal directly with trust property, the trustee could, for example, acquire an interest in trust property with the consent of the beneficiary as long as the beneficiary knew of all material facts and the transaction was fair and reasonable if challenged in a court.[81] The fundamental move that transformed a rigid rule into a flexible one was to analogize the disinterested members of the corporate board of directors to the beneficiary or beneficiaries.[82] By the early 1900s, approval of an interested transaction by a majority of the disinterested directors informed of all material facts (and constituting a quorum) could legitimize the transaction as long as the transaction was judged to be fair to the corporation if challenged in court.[83]

The evolving common-law standards were subsequently codified in corporate statutes such as Delaware's section 144, enacted in 1967 as part of a general revision of the state's General Corporation Law.[84] Section 144 reverses the old trust law rule by providing that a self-dealing transaction is not void or voidable solely for that reason. Rather, the transaction can be valid if it is approved by a majority of the disinterested directors who are informed of all material information, if it is approved by an informed vote of the shareholders, or if it is fair to the corporation.[85]

Section 144, however, still left to the courts the question of the standard for validity and the burden of proof in cases that meet the statutory threshold. Under current Delaware law, the basic rule governing transactions between an interested director or shareholder and the firm is one of "entire fairness:" it will not be valid unless the defendant demonstrates that it is entirely fair to the firm.[86] But the burden and standard can shift. If a transaction between an interested but noncontrolling director and the firm is approved by the disinterested directors, then the standard shifts to the business judgment rule, with the burden on the plaintiffs.[87] By constrast, in a transaction between a controlling shareholder or director and the firm which is approved by disinterested directors, the burden shifts to the plaintiffs but the standard remains "entire fairness."[88]

The current state of the law raises two questions. First, as compared to

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[81] RESTATEMENT OF TRUSTS § 170 cmt. on Subsection (2).

[82] Marsh, *supra* note 79, at 39-40.

[83] *Id.*

[84] *See* S. Samuel Arsht & Walter K. Stapleton, *Delaware's New General Corporation Law: Substantive Changes*, 23 BUS. LAW. 75, 75 (1967).

[85] According to Arsht and Stapleton, the common law rule in effect prior to the enactment of section 144 was that a sufficient number of directors to constitute a quorum in themselves was required to approve an interested transaction. *Id.* at 81. The new rule modified the quorum requirement and provided for greater clarity by providing three actions that could be taken so that an interested transaction was not automatically void or voidable. *Id.*

[86] See *Cooke v. Oolie*, 1997 Del. Ch. LEXIS 92, and cases discussed and cited therein.

[87] *Id.*

[88] *Id.*

the enforcement of the duty of care, why is the review so intrusive? Second, as compared to trust law, why is the law so flexible? The answer to the first question is fairly obvious: the possibility of self-dealing provides too great a temptation to be controlled by the normal, socially acceptable internal firm constraints. There are a million and one ways to evade such a rule. And, if one can get seriously rich, one can ignore the effect on one's reputation.

But this leads to Marsh's question: why not retain the strict, uncompromising trust law duty of loyalty? Clark offers three explanations: the capture of the courts and legislatures by managers who wanted to self-deal; a general societal shift toward more flexible rules; or the judiciary becoming enlightened to the potential of such self-dealing to the corporation.[89] Clark argues that the migration from a strict rule to a flexible standard may have resulted from the changing population of cases coming before the courts, with an increasing number involving close corporations.[90] Because Clark sees minimal benefits from interested transactions in the publicly held corporation, he concludes that a flat prohibition of such transactions makes sense.[91]

Focusing on the distinction between intrafirm versus market transactions provides a basis for preferring a flexible rule, even in the publicly held corporation. As discussed above, the types of relationships that rely on trust law are very different from those that rely on corporate law. Moreover, the institutional structure of the corporate and trust contexts are likewise fundamentally different. These differences together shift the balance of costs and benefits toward a more flexible rule for corporations.

Recall that, according to economic theories of the firm, relationships are brought within the firm when they are open ended in time and scope, transaction intensive, and involving physical assets that are illiquid and difficult to value. When relationships have this character, as dramatically demonstrated by technology companies, permitting interested transactions (with protections) is more likely to be valuable to the corporation. Many corporations benefit by having diverse directors who are suppliers, customers, or co-adventurers with the corporation. Such directors bring knowledge that is vital to the corporation. But their presence also increases the likelihood that they will have an interest in a given transaction that is potentially valuable to the corporation.

But can such flexibility work? Given the difficulties for a court in intervening in intrafirm matters, difficulties that shape the enforcement of the duty of care, how is it that courts are willing or able to intervene, even in duty of loyalty situations? Here we see another difference that context makes. In the corporate context, courts piggy back on a key institutional

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[89] CLARK, *supra* note 80, at 161-66.

[90] *Id.* at 165-66.

[91] *Id.* at 180-89.

feature of the corporate form that is absent in the typical trust context: the board of directors and disinterested decision makers.

Conflicts of interest are pervasive. Within the corporation, individual actors often act to further their own goals even if they are in conflict with corporate goals. Many acts are minor. Employees sometimes shirk, that is, work below the accepted level of performance. At the same time, almost all individuals legitimately vary their work effort in response to personal factors and such behavior can be beneficial to the firm. The two types of behavior may be difficult to differentiate. Firms control work effort through a variety of intrafirm mechanisms, including merit pay, promotions and other such devices that align the interests of employees with those of the firm. With frequent interacting, the few bad players who find shirking more profitable than any alternative can be identified and punished through demotions or discharge. In these later cases, the disciplinary process tends to rely on the judgment of disinterested individuals, such as supervisors, whose own incentives are in alignment with those of the firm. The same type of mechanism applies throughout the organization, even to executive officers and directors. For interested director transactions, the other disinterested directors have interests that remain aligned with the corporation.

By tinkering with the standard of review and the burden of proof, courts are able to channel transaction into an institutional structure—decisions by disinterested directors—that reduces the potential for serious self-dealing. The existence of the board of directors, absent from the paradigmatic trust form, allows the courts to adopt this flexible legal check without excessive cost. By harnessing the firm's own mechanism, the worst cases will likely be prevented by the directors themselves. Those that slip through will often find their way into court where the court will need to apply entire fairness scrutiny. In this way, courts maintain their focus on procedural review, and minimize their substantive review of transactions, a review that they legitimately feel uncomfortable about performing.

III. CONCLUSION

When corporate law emerged out of trust and agency law, the fiduciary duties governing the obligations of trustees and principles were transplanted into corporate law. But legal transplants, whether from one legal system to another or from one doctrinal area to another, are tricky because of the differences in context. Legal transplants often have difficulty adjusting to a new body of law. In the case of (a legally enforced) duty of care, the rejection process, triggered by *Smith v. Van Gorkom*, was swift and nearly complete.

The duty of care in trust and agency law traditionally incorporated a judicially enforced negligence standard. After the duty of care was transplanted to corporate law, corporate law slowly began to flirt with describing the content of the duty using negligence language, albeit surprisingly

slowly. Remarkably, it was not until the 1960s that Delaware first began to articulate the corporate law duty of care in negligence terms. Even more remarkably, it was not until *Smith v. Van Gorkom* that a Delaware court first imposed monetary liability on directors for a negligent breach of the duty of care. In the uproar that followed, section 102(b)(7) was enacted, ensuring that *Van Gorkom* was not only the first, but also the last such case.

Why did *Smith v. Van Gorkom* fail so badly? Our argument is that a negligence-based standard works in trust and agency law because those relationships are fundamentally market-based and contractual, where legal enforceability normally and effectively applies. The relationship between corporate directors and shareholders, however, is not market but intrafirm based. Inside the firm, nonlegally enforceable rules and standards apply. Indeed, the firm–market boundary is intended to be a jurisdictional boundary between legal governance and self-governance.

Transplanting the duty of care from trust and agency law into corporate law fails because the transplant moves across the firm–market boundary, a change in context that is fundamental. Relationships are brought into the firm in order to take advantage of the largely nonlegally enforced intrafirm governance structure and to eschew the legal enforcement of market relations.

Traditionally, the role of the business judgment rule has been to protect this jurisdictional boundary. As long as courts concluded that the business judgment rule applied, the duty of care remained both safely and entirely harmlessly transplanted. But once a "gross negligence" standard was incorporated into the business judgment rule itself, the inherent potential for mischief was unleashed. With *Van Gorkom*, the harmless flirtation with negligence language became a truly dangerous liaison, so dangerous that it was quickly ended by legislation.

The transplant of the duty of loyalty has fared better, for two reasons. First, the duty of loyalty in corporate law needs to rely in part on judicial enforceability to restrain stealing and other egregious bad play by corporate insiders. The soft restraints of the firm are too weak to control the more egregious cases of self-dealing. Hence, the court's enforcement of the duty of loyalty did not violate a strict jurisdictional boundary. Second, the duty of loyalty that is applied in the corporate context is much more nuanced than the rigid rules applied in trust and agency, and takes advantage of the unique institutional form. To a great extent, the courts have shifted the enforcement of the duty of loyalty to the corporation and its incentive-based mechanism by making disinterested directors the first line of defense against wrongful self-dealing. The existence of the board of directors, absent in the paradigmatic trust and agency contexts, makes this possible. It is only the cases that slip through the corporation's own self-governing mechanisms that wind their way across the jurisdictional boundary and into the courts.

Smith v. Van Gorkom is a cautionary tale of the dangers that arise when

the logic of legal concepts is divorced from the economic context of a relationship. Borrowing concepts and rules is critical to the legal enterprise, but, in doing so, one must be extremely sensitive to differences in context lest the borrowing becomes toxic.