5-2019

Toward a Horizontal Fiduciary Duty in Corporate Law

Asaf Eckstein
Ono Academic College

Gideon Parchomovsky
University of Pennsylvania Law School

TOWARD A HORIZONTAL FIDUCIARY DUTY IN CORPORATE LAW

Asaf Eckstein† & *Gideon Parchomovsky*††

Fiduciary duty is arguably the single most important aspect of our corporate law system. It consists of two distinct subduties—a duty of care and a duty of loyalty—and it applies to all directors and corporate officers. Yet, under extant law, the duty only applies vertically, in the relationship between directors and corporate officers and the firm. At present, there exists no horizontal fiduciary duty: directors and corporate officers owe no fiduciary duty to each other. Consequently, if one of them fails her peers, they cannot seek direct legal recourse against her even when they stand to suffer significant reputational and financial losses. This state of affairs is undesirable not only from a fairness perspective, but also from an efficiency standpoint as it raises governance costs for firms and may undermine their ability to attract skillful officers and directors.

In this Article, we call for the introduction of a horizontal fiduciary duty among directors and corporate officers. The proposed duty would complement, rather than replace, the fiduciary duty that corporate officers owe the corporation and the shareholders. We argue that the institution of a horizontal fiduciary duty would (1) lead to improved decision making and information sharing on boards; (2) enable board members to vindicate themselves in situations in which another board member is the one to breach the fiduciary duty; (3) attract more capable individuals to serve as directors; and (4) improve corporate management and governance.

† Law Lecturer, the Ono Academic College.
†† Robert G. Fuller, Jr. Professor of Law, University of Pennsylvania Law School, and Professor of Law, Bar-Ilan University School of Law, Israel. We are grateful to Abraham Bell, Zohar Goshen, Assaf Hamdani, Sharon Hannes, Amir Licht, Adi Libson, Peter Siegelman, and Alex Stein, for invaluable comments and criticisms.

INTRODUCTION

The duty of care and the duty of loyalty are the twin pillars on which corporate law is constituted.[1] Together, they form the fiduciary duty that guides and binds every corporate officer and director.[2] The duty of care requires directors and officers to exercise the level of care that a prudent person would use under similar circumstances.[3] The duty of loyalty requires directors and officers to refrain from benefiting themselves at the expense of the corporation that they serve.[4] Critically, though, both duties are one-dimensional. They only apply vertically in the relationship between the duty-bearers and the corporation.[5] They do not avail horizontally in the relationship among corporate officers and directors inter se.

---

1 *See* Polk v. Good, 507 A.2d 531, 536 (Del. 1986) ("In performing their duties the directors owe fundamental fiduciary duties of loyalty and care to the corporation and its shareholders.").

2 *See* Marcia M. McMurray, *An Historical Perspective on the Duty of Care, the Duty of Loyalty, and the Business Judgment Rule*, 40 VAND. L. REV. 605, 606 (1987).

3 *In re* Walt Disney Co. Derivative Litig., 907 A.2d 693, 749 (Del. Ch. 2005).

4 Guth v. Loft, Inc., 5 A.2d 503, 510 (Del. 1939) ("Corporate officers and directors are not permitted to use their position of trust and confidence to further their private interests.").

5 Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 367 (Del. 1993) ("Duty of care and duty of loyalty are the traditional hallmarks of a fiduciary who endeavors to act in the service of a corporation and its stockholders.").

This Article calls for the recognition of a horizontal duty of care and a duty of loyalty among directors and corporate officers inter se. The new duty we envision is supposed to complement, not replace, the duties directors and officers owe to the corporation.

To understand the motivation behind our proposal, one only needs to recall the classic cases of *Smith v. Van Gorkom*[6] and *In re Walt Disney*.[7] *Van Gorkom* involved a successful challenge to the sale of Trans Union, a Delaware corporation.[8] The transaction was masterminded by Mr. Van Gorkom, the CEO and chairman of the board of Trans Union, who was "familiar with acquisition procedures, valuation methods, and negotiations."[9] Van Gorkom recommended the proposed transaction.[10] His opinion carried great weight with his colleagues and, following a two hour discussion, the board approved the sale and its terms.[11] Pursuant to the board's approval, a class action was filed against Trans Union and its board.[12] At the heart of the challenge lies the agreed upon sale price of $55 per share that Van Gorkom and Trans Union's chief financial officer had agreed upon without any research or external validation.[13] A majority of the Delaware Supreme Court accepted the class action, ruling that the board breached its fiduciary duty by making an ill-informed decision.[14] Despite the fact that Van Gorkom was the driving force behind the decision and the other directors played a merely passive role, the court did not differentiate among the board members in terms of their responsibility for the decision and assigned collective liability to all of them.[15] In the aftermath of the litigation, the directors agreed to pay $23 million to the plaintiffs as

---

6 488 A.2d 858 (Del. 1985).

7 Disney, 907 A.2d 693; *In re* Walt Disney Co. Derivative Litig., 906 A.2d 27, 66–67 (Del. 2006).

8 *See Van Gorkom*, 488 A.2d at 864.

9 *Id.* at 866.

10 *Id.*

11 *See id.* at 869.

12 *Id.* at 863–64.

13 *Id.* at 877.

14 *Id.* at 893; Jonathan R. Macey, *Smith v. Van Gorkom: Insights About C.E.O.s, Corporate Law Rules, and the Jurisdictional Competition for Corporate Charters*, 96 NW U. L. REV. 607, 614–15 (2002) (citing *Van Gorkom*, 488 A.2d at 894) (observing that the "Trans Union's Directors have been the victims of a 'fast shuffle' by Van Gorkom and Pritzker [the acquirer].").

15 It should be noted that in this case, the directors elected to defend themselves collectively. *Van Gorkom*, 488 A.2d at 889.

part of a settlement that was entered between the parties.[16] Van Gorkom, by not disclosing material information to his peers, failed them. But he owed them no fiduciary duty and they could not seek legal recourse against him.

The (in)famous case of Disney involved a derivative suit against Disney's directors and officers for damages allegedly caused by the 1995 hiring of Michael Ovitz as the President of The Walt Disney Company and his 1996 firing.[17] In this case, Michael Eisner, Disney's Chairman and Chief Executive Officer, and Irwin Russell, a director and head of the compensation committee, approached Ovitz about joining Disney and entered into negotiations with him.[18] By mid-July 1995, those negotiations were in full swing. Raymond Watson, a member of Disney's compensation committee and a former Disney board chairman helped structure Ovitz's compensation package.[19] In September 1995, the committee voted unanimously to approve the Ovitz Employment Agreement's terms.[20] Although the board, as a whole, approved Ovitz's hiring, it was clear that Eisner and Watson orchestrated the deal.[21] They possessed intimate knowledge about the terms of the deal and the other directors clearly deferred to their superior knowledge and expertise.[22] After less than a year Ovitz was terminated without cause and, due to the way in which his compensation package

16 Stephen A. Radin, *The Director's Duty of Care Three Years After* Smith v. Van Gorkom, 39 HASTINGS L.J. 707, 719 (1988).

17 *In re* Walt Disney Co. Derivative Litig., 906 A.2d 27, 35 (Del. 2006).

18 *Id.* at 36.

19 *Id.* at 38.

20 *Id.* at 40.

21 At first phases, "Eisner never called a board meeting for the specific purpose of discussing the possibility of hiring Ovitz, but at various times Eisner did contact board members on an individual basis." *In re* Walt Disney Co. Derivative Litig., 907 A.2d 693, 699 n.6 (Del. Ch. 2005). As noted, "Eisner was 'on a hunt' to bring Ovitz to Disney." *Id.* at 702 (footnote omitted) (quoting Tr. 4173:24-4175:12 (Eisner)). "Russell, per Eisner's direction, assumed the lead role in negotiating the financial terms of the contract." *Id.* "Up until this point, only three members of Disney's board of directors were in the know concerning the status of the negotiations with Ovitz or the particulars of the OEA[—]Eisner, Russell and Watson." *Id.* at 706. Russell, Raymond Watson, and Graef Crystal were responsible for conducting analysis of Ovitz's employment agreement. *Id.* at 704. Eisner and Watson led the discussions and explanations to Disney's board regarding Ovitz's employment agreement. *See id.* at 710.

22 Before approving Ovitz's employment agreement, Watson presented to the Compensation committee the process underlining the OEA. Some of the committee's members "could not recall whether Watson had actually distributed copies of" spreadsheet analysis performed by him, *Id.* at 709 n.82, but they testified "that they believed they had received sufficient information from Russell's and Watson's presentations," *Id.* at 709.

was structured, he walked away with $130 million.[23] The Chancery Court imposed no liability on the board, explaining that the directors "were at most ordinarily negligent,"[24] but "did not act in bad faith,"[25] and were thus sheltered from liability by the business judgment rule.[26] At the same time, the court was highly critical of the board, noting that "[f]or the future, many lessons of what not to do can be learned from defendants' conduct here,"[27] and expressing hope "that this case will serve to inform stockholders, directors and officers of how the Company's fiduciaries underperformed."[28] The Supreme Court echoed this criticism, expressing its dissatisfaction with Disney's directors and officers.[29] So, while the defendants escaped legal liability, their reputations were severely tarnished and their prospects of serving on future boards were diminished.[30] In this case too, the court chastised the board collectively, even though some of directors clearly shouldered more blame than others. In the absence of a horizontal fiduciary duty, though, they had no ready way of exonerating themselves and no hope of setting the record straight.

These and many other cases represent the realities of corporate boards. Although boards are often portrayed as monolithic entities comprised of equal peers, this ideal portrayal is a far cry from the real world, where boards are comprised of members with different skill sets, experiences, leverages, and personalities.[31] Board decisions are the product of the interaction among directors.[32] And, although individual directors can disagree with each other, it is a well-known fact that there is

---

23 *In re* Walt Disney Co. Derivative Litig., 906 A.2d 27, 35 (Del. 2006).

24 Disney, 907 A.2d at 760.

25 *Id.*

26 *Id.*

27 *Id.*

28 *Id.* at 772.

29 *In re* Walt Disney Co. Derivative Litig., 906 A.2d 27, at 66–67 (Del. 2006).

30 *See* Ehud Kamar, *A Regulatory Competition Theory of Indeterminacy in Corporate Law*, 98 COLUM. L. REV. 1908, 1919 (1998) (noting that "[w]hile litigation is unlikely to cost [corporate managers and directors] their jobs, liability can damage their reputations and future careers"); *see also* Edward B. Rock, *Saints and Sinners: How Does Delaware Corporate Law Work?*, 44 UCLA L. REV. 1009, 1104 (1997) (explaining how "[a] system that relies on public shaming is perfectly suited to such contexts: The cost to the actor—the disdain in the eyes of one's acquaintances, the loss of directorships, the harm to one's reputation—may often be sufficiently great to deter behavior, even without anything more").

31 *See infra* subpart III.A.

32 *See* Barry D. Baysinger & Henry N. Butler, *Corporate Governance and the Board of Directors: Performance Effects of Changes in Board Composition*, 1 J.L. ECON. & ORG. 101, 107–08 (1985) (describing the collective nature of boards of directors).

strong pressure on boards to acquiesce and play along.[33] This is especially true when the decision at hand falls within the domain of expertise of a particular board member and the board operates under conditions of exigency.

Furthermore, in discharging their duties toward the firm, directors must invariably depend on other corporate officers.[34] Directors usually do not have access to independent information sources and they normally do not engage in specific fact finding about the day-to-day operations of the firm.[35] Typically, the board rests its decisions on information it receives from the other organs of the firm.[36] The successful operation of boards, therefore, necessitates an environment of trust within the firm. The same is true, albeit to a lesser degree, of other corporate officers. Corporate officers possess expertise in certain areas, such as business, engineering, accounting or law, but they, too, must rely on their peers in matters that fall outside of these areas or in making decisions that depend on factual predicates that they cannot independently verify.

This, of course, raises the question whether liability for breaches of fiduciary duty is assigned individually or collectively. Surprisingly, extant law on the nature of civil liability of directors and corporate officers is unclear.[37] The consensus among corporate law scholars is that in cases involving breaches of the duty of care, courts tend to treat the board as a unitary whole and assign responsibility to all directors collectively, whereas in cases of breach of the duty of loyalty, liability is assessed individually.[38] Yet, a careful perusal of the caselaw

---

33 *See, e.g.*, Marleen A. O'Connor, *The Enron Board: The Perils of Groupthink*, 71 U. CIN. L. REV. 1233, 1257–93 (2003) (discussing the board's contribution to Enron's failure)); Julian Velasco, *Structural Bias and the Need for Substantive Review*, 82 WASH. U.L.Q. 821, 824, 851–65 (2004) (elucidating the phenomenon of "structural bias," which "refers to the prejudice that members of the board of directors may have in favor of one another" and calling to apply a judicial review of the substantive merit of directors' decision making in cases involving structural bias).

34 *See* Stephen M. Bainbridge, *Why a Board? - Group Decision making in Corporate Governance*, 55 VAND. L. REV. 1, 7 (2002) (noting that directors delegate responsibility to top management and monitor their performance).

35 *See id.* at 5 (explaining that "[t]he modern public corporation is too big for the board to manage on . . . a day-to-day basis").

36 *See id.* at 7 (describing the information gathering and monitoring process of corporations).

37 Darian M. Ibrahim, *Individual or Collective Liability for Corporate Directors?*, 93 IOWA L. REV. 929, 935 (2008) ("Existing law on the individual/collective question is difficult to decipher.").

38 *Id.* at 935 ("Duty of loyalty claims tend to be analyzed using an individual approach, while duty of care claims tend to be analyzed using a collective approach."); *see also* Roberta Romano, *Corporate Governance in the Aftermath of the*

reveals a more nuanced picture under which the choice between collective and individual liability is largely case specific, depending on the legal context and the claims involved.[39] As a result of the uncertainty that surrounds directors' liability, all directors are potentially exposed to the liability for breaches of fiduciary duty even if they were not actively involved in the problematic conduct or omission. Indeed, liability may even be assigned to absentee directors[40] and dissenting directors whose dissent has not been recorded in the minutes.[41] Worse yet, even board members who choose to resign in response to a decision they opposed are not immune from liability.[42]

The tendency to view board members collectively is much more pronounced in administrative and criminal actions.[43] When launching an investigation against a corporation for suspected illicit activities, the Department of Justice (DOJ), the Securities and Exchange Commission (SEC), and other law enforcement agencies approach the board as a single entity and do not distinguish among individual board members in terms of their responsibility.[44] Many investigations end up in plea agreements and pretrial diversion agreements, specifically deferred prosecution and non-prosecution agreements[45] that as-

---

Insurance Crisis, 39 EMORY L.J. 1155, 1178 n.39 (1990) (suggesting that "[a] duty of care violation is likely to involve the entire board, whereas a duty of loyalty violation tends to be limited to directors (typically insiders) who have personally benefited from a transaction").

39 For discussion, see Part I, *infra*.

40 Ibrahim, *supra* note 37, at 933 & 933 n.11.

41 Thus, with regard to payments made in violation of dividend restrictions, the Del. Code Ann. tit. 8 § 174(a) (2001) states that: "Any director who may have been absent when [an unlawful dividend or stock repurchase] was done, or who may have dissented from the act or resolution by which the same was done, may be exonerated from such liability by causing his or her dissent to be entered on the books containing the minutes of the proceedings of the directors at the time the same was done, or immediately after such director has notice of the same." *See also* JAMES D. COX & THOMAS LEE HAZEN, CORPORATIONS 1253 (2d ed., 2003).

42 *See* Rich *ex rel.* Fuqi Inter., Inc. v. Yu Kwai Chong, 66 A.3d 963, 980 n.138 (Del. Ch. 2013) (holding that directors would not be "automatically exonerated because of their resignations"); *see also In re* Puda Coal Stockholders' Litig., C.A. No. 6476-CS, at 16:9–11 (Del. Ch. Feb. 6, 2013) (bench ruling) (holding that three directors that resigned "leave the company under the sole dominion of a person they believe has pervasively breached his fiduciary duty").

43 *Infra* note 129.

44 *Id.*

45 Under deferred prosecution and non-prosecution agreements, corporations admit to criminal wrongdoing and agree to pay monetary sanctions while avoiding formal conviction. *See* Jennifer Arlen & Marcel Kahan, *Corporate Governance Regulation through Nonprosecution*, 84 U. CHI. L. REV. 323, 325 (2017) (describing common arrangements in which "the prosecutor agrees not to pursue a criminal conviction of a firm, but nevertheless typically imposes financial sanctions on the firm. In return, the firm usually agrees to cooperate in the investiga-

sign blame to the board as a whole without apportioning it among its members. Individual board members who wish to dissociate themselves from the failures of their colleagues and clear their names have no means of legal redress. Under current law, there is no cause of action they can assert.

To address the plight of individual directors and corporate officers, and to improve corporate governance more generally, we call for the recognition of a fiduciary duty among directors and corporate officers vis-à-vis one another. Directors, by virtue of their shared responsibility, must rely on each other and trust one another to carry out their duties successfully. Failure by one director to dutifully perform her tasks is liable to affect other directors. The successful operation of boards is predicated, in other words, on a system of trust. It stands to reason, therefore, that directors should owe each other a fiduciary duty. The implementation of our proposal would have enabled the passive directors in *Van Gorkom* and *In re Disney* to seek legal recourse against the directors who breached their trust and led them astray. Similarly, it would allow directors, whose companies were implicated in criminal and regulatory violations, to prove that they were not involved in the wrongdoing and seek recompense from board members who suppressed information from them or misled them for the reputational and other harms they have suffered.

The introduction of a horizontal fiduciary duty among corporate officers and directors would have four salutary effects. First, the fiduciary duty we propose would firm up the incentives of corporate officers and directors to be diligent in the performance of their duties. This, in turn, would lead to improved information-sharing and decision making on boards. Second, the independent cause of action we seek to create would enable individual board members to vindicate themselves and restore their reputation if they were led astray or misled by their peers. Third, it would attract more capable individuals to serve on boards, at a lower cost to the corporation itself. Giving individual directors an independent cause of action that protects their reputation should increase the willingness of skilled individuals to act as directors and reduce the compensation they require. Fourth, and most importantly, empowering individual directors to sue for breach of fiduciary

tion and admit to the facts of the crime"); Brandon L. Garrett, *Structural Reform Prosecution*, 93 VA. L. REV. 853, 855 (2007) (arguing that deferred prosecution agreements and non-prosecution agreements still impose rigorous requirements on corporations).

duty is liable to improve corporate management across the board. Corporate officers and directors have superior information about the corporation and can bring to light evidence that other plaintiffs may not be able to produce.[46] The threat of being sued by a fellow officer or director would consequently improve the diligence and heighten the loyalty exercised by all board members and corporate officers. Importantly, our proposal would give corporate officers and directors who were harmed by the misdeeds and omissions of their colleagues an independent cause of action exercisable irrespective of harm to the corporation itself.[47]

Structurally, the Article unfolds in five parts. In Part I, we discuss the duties of corporate officers and directors. In Part II, we explore the contours of officers' and directors' liability for breaches of the duties owed to the corporation. In Part III, we unveil the internal dynamics that exist within firms and explain how they affect individual choices and collective decision making. In Part IV, we introduce our proposal to recognize a horizontal fiduciary duty that will avail among corporate officers and directors vis-à-vis one another. In Part V, we assess the impact of exculpation, insurance, and indemnification arrangements on our proposal. A short conclusion ensues.

---

46 In that respect see James D. Cox & Randall S. Thomas, *Common Challenges Facing Shareholder Suits in Europe and the United States*, 6 EUR. COMPANY & FIN. L. REV. 348, 355 (2009) (discussing the informational constraints faced by plaintiffs in derivative suits); Sean J. Griffith, *Correcting Corporate Benefit: How to Fix Shareholder Litigation By Shifting the Doctrine on Fees*, 56 B.C. L. REV. 1, 53–54 (2015) ("The defendants, after all, possess all relevant information about what, in fact, triggered the relief. The plaintiffs do not.").

47 One may argue, at this point, that the availability of directors and officers insurance as well as exculpatory clauses renders our proposal superfluous. Directors are insured against losses resulting from breaches of their fiduciary duties and are therefore indifferent to their exposure to liability. This argument is flawed for several reasons. First, directors and officers insurance is not available in all corporations. Second, cases of recklessness, gross negligence, and intent are generally excluded from coverage. Relatedly, a judicial determination of directors' way of acting is not an exact science and even directors that were not reckless or grossly negligent are exposed to the risk of judicial mistakes. Third, liability findings affect directors' future insurance premiums. Fourth, insurance does not offer adequate coverage for reputational harms and lost future opportunities to serve on boards resulting therefrom. Fifth, and finally, insurance is costly. It exists to address cases of failure. Policymakers should therefore strive to improve the mechanisms of corporate governance and not increase reliance on insurance. For further discussion, see Part V.

I
The Increasing Legal Exposure of Directors and Corporate Officers

The law views directors and corporate officers as fiduciaries of the corporation and its shareholders.[48] The imposition of a fiduciary duty on directors and officers is intended to align their interests with those of the corporation and ensure that they act with the best interest of the corporation in mind.[49] The fiduciary duty of directors and officers is typically broken down into two specific duties: a duty of care and a duty of loyalty.[50] The duty of care requires a fiduciary to be aware of all reasonably available material information before making a business decision.[51] The fiduciary must act with a level of care that an ordinarily careful and prudent person would employ under similar circumstances.[52] In reviewing whether a director or an officer has satisfied her duty of care, courts have examined the informational basis available to a director and the decision making process followed by the board.[53]

The duty of loyalty has been defined by Delaware courts in broad and unyielding terms, requiring "an undivided and unselfish loyalty to the corporation [and] demand[ing] that there

---

48 *See* Guth v. Loft, Inc., 5 A.2d 503, 510 (Del. 1939).

49 The need to align interests of officers and directors with those of the corporation and its shareholders is the heart of the well-known agency problem resulting from the separation of ownership and control. For an explanation of the agency problem in business firms, see Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 308–43 (1976) (discussing agency costs alongside the agency problem); John Armour, Henry Hansman & Reiner Kraakman, *What Is Corporate Law*, in THE ANATOMY OF CORPORATE LAW 1, 2 (2d ed. 2009) (explaining that "much of corporate law can usefully be understood as responding to three principal sources of opportunism: [among them] conflicts between managers and shareholders").

50 *See* Guth, 5 A.2d at 510 ("Corporate officers and directors are not permitted to use their position of trust and confidence to further their private interests. While technically not trustees, they stand in a fiduciary relation *to the corporation and its stockholders*." (emphasis added)). This is the case not only in Delaware but also in other states.

51 STEPHEN A. RADIN, THE BUSINESS JUDGEMENT RULE: FIDUCIARY DUTIES OF CORPORATE DIRECTORS 1 (6th ed., 2009).

52 Graham v. Allis-Chalmers Mfg. Co., 188 A.2d 125, 130 (Del. 1963); *In re* Walt Disney Co. Derivative Litig., 907 A.2d 693, 749 (Del. Ch. 2005).

53 Smith v. Van Gorkom, 488 A.2d 858, 871 (Del. 1985) (finding directors liable for not making informed and deliberate decisions); Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) ("[D]irectors have a duty to inform themselves, prior to making a business decision, of all material information reasonably available to them."). For a detailed description of the evolution of duty of care, see Stephen J. Lubben & Alana Darnell, *Delaware's Duty of Care*, 31 DEL. J. CORP. L. 589, 594–99 (2006) (focusing on the "inherent tension in corporate law between discretion and accountability" as a framework for the development of the duty of care).

. . . be no conflict between duty and self-interest."[54] The duty of loyalty imposes both affirmative and negative obligations on the duty-bearer. Affirmatively, it tasks a corporate officer or director with the responsibility "to protect the interests of the corporation committed to his charge" with the highest level of scrupulousness.[55] Negatively, it prohibits a corporate officer or director from "work[ing] injury to the corporation, or . . . depriv[ing] it of profit or advantage which his skill and ability might properly bring to it, or . . . enabl[ing] it to make in the reasonable and lawful exercise of its powers."[56] Stated in more general terms, the duty of loyalty prohibits self-dealing by directors and officers and requires that they act in good faith and in a manner they reasonably believe to be in the best interests of the corporation and its stockholders.[57] Some have even argued for a broader definition of the duty of loyalty, suggesting that it should be construed as mandating an "affirmative devotion" to the firm.[58]

While the twin duties of care and loyalty have been part and parcel of our corporate law ever since its inception,[59] in the last few decades two important developments have combined to enhance the legal exposure of directors and officers to civil suits and criminal and administrative enforcement actions involving claims of breaches of the duty of care and duty of loyalty. First, there was a paradigm shift from board-centric to

54 Guth, 5 A.2d at 510.

55 *Id.*

56 *Id*; *see also* Brehm v. Eisner, 746 A.2d 244, 257–58 (Del. 2000) (affirming dismissal of breach of loyalty claims based upon evidence of lack of personal benefit to director who approved the transaction).

57 Ivanhoe Partners v. Newmont Mining Corp., 535 A.2d 1334, 1345 (Del. 1987) (holding that directors have an "affirmative duty to protect the interests of the corporation, but also an obligation to refrain from conduct which would injure the corporation and its stockholders or deprive them of profit or advantage. In short, directors must eschew any conflict between duty and self-interest"). For further discussion, see Leo E. Strine, Jr., Lawrence A. Hamermesh, R. Franklin Balotti & Jeffrey M. Gorris, *Loyalty's Core Demand: The Defining Role of Good Faith in Corporation Law*, 98 GEO. L.J. 629, 634 (2010) ("[I]t has been traditional for the duty of loyalty to be articulated capaciously, in a manner that emphasizes not only the obligation of a loyal fiduciary to refrain from advantaging herself at the expense of the corporation but, just as importantly, to act affirmatively to further the corporation's best interests."). Finally, see Lyman Johnson, *After Enron: Remembering Loyalty Discourse in Corporate Law*, 28 DEL. J. CORP. L. 27, 37–42 (2003) (discussing the various meanings of loyalty).

58 *See* Andrew S. Gold, *Purposive Loyalty*, 74 WASH. & LEE L. REV. 881, 882 (2017) (defining this specific "strand" of corporate loyalty as one that advances the firm's particular purposes).

59 *See* Tamar Frankel, *Fiduciary Law*, 71 CAL. L. REV. 795, 795 (1983) ("[T]he fiduciary duties of partners, corporate directors, and officers originated with the formation of partnerships and corporations . . . .").

shareholder-centric governance of public companies.[60] Shareholder activism in the U.S. has increased significantly over the past several years.[61] Prompted at least in part by calls from the legal academy,[62] "institutional investors have become much more open to hearing from, and supporting, 'activist' investors who have amassed significant investments in companies and who purport to know better than management and the incumbent board the steps a company should be taking to increase shareholder value."[63] This change in the behavior of institutional investors has resulted in, among other things, an increase in the number of suits brought against directors and officers and has resulted in greater scrutiny of boards, managements, and their operations.[64]

Second, the DOJ, SEC, and other governmental agencies have stepped up their enforcement efforts against U.S. companies and foreign companies listed in the U.S.[65] In February 2017, the DOJ's Criminal Division Fraud Section issued a new guideline for the Evaluation of Corporate Compliance Pro-

---

60 *See, e.g.*, Edward B. Rock, *Adapting to the New Shareholder-Centric Reality*, 161 U. PA. L. REV. 1907, 1911–26 (2013) (describing the transformation of the U.S. system from manager-centric to a shareholder-centric model).

61 *See* Joseph Fuller, *How Activist Investors (Like Carl Icahn) Became Powerful Business Forces*, FORBES (Nov. 17, 2015, 12:17 PM), https://www.forbes.com/sites/hbsworkingknowledge/2015/11/17/how-activist-investors-like-carl-icahn-became-powerful-business-forces/#5fde935742be [https://perma.cc/3DLL-FZLH] ("[A]ctivist investors pulled off a remarkable metamorphosis over the course of a generation. Once reviled as villains operating on the fringes of the market, they are now powerful forces at work in the mainstream of business.").

62 *See* Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV 833, 851 (2005).

63 Marc S. Gerber, *US Corporate Governance: Board of Directors Face Increased Scrutiny*, SKADDEN'S 2014 INSIGHTS-GOVERNANCE (Jan. 16, 2014), https://www.skadden.com/insights/us-corporate-governance-boards-directors-face-increased-scrutiny [https://perma.cc/V6NC-KS2H]; *see also* Joseph Fuller, *How Activists Investors (Like Carl Icahn) Became Powerful Business Force*, FORBES (Nov. 17, 2015, 12:17 PM) (noting that "it was the many institutional investors who eventually embraced activists in their search for better returns who gave these hedge funds their real clout"); Charles Nathan, *Debunking Myths About Activist Investors*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Mar. 15, 2013), https://corpgov.law.harvard.edu/2013/03/15/debunking-myths-about-activist-investors/ [https://perma.cc/R7UP-3UK8] ("In fact, perhaps the most important change in the activist investor game plan over the past several years has been the increasingly sympathetic hearing activists receive from conventional institutional investors.").

64 Gerber, *supra* note 63.

65 *See, e.g.*, Amy Deen Westbrook, *Double Trouble: Collateral Shareholder Litigation Following Foreign Corrupt Practices Act Investigations*, 73 OHIO ST. L.J. 1217, 1220 (2012) ("Between 1977 and 2007, there were a total of approximately 105 [FCPA] actions . . . . [Between 2007 and 2012], DOJ and the SEC have brought over 230 enforcement actions, with more investigations pending" (footnote omitted)).

grams.[66] The guideline includes key compliance program evaluation topics and questions that prosecutors should consider in "conducting an investigation of a corporate entity, determining whether to bring charges, and negotiating plea or other agreements."[67] Among other topics, the guideline puts strong emphasis on the oversight duty of directors.[68] It invites prosecutors to examine the expertise of board members in compliance issues and the manner in which they discharged their oversight responsibilities.[69] The enforcement campaigns against U.S. corporations often result in pretrial diversion agreements, under which a firm admits to wrongdoing and agrees to pay hefty fines in exchange, for being put on probation for several years.[70]

The criminal and administrative enforcement actions taken against U.S. companies typically fuel private lawsuits against the companies involved.[71] Indeed, in this context, administrative and criminal actions and civil suits are inextricably related.[72] Admission of wrongdoing by corporations as part of their agreements with the authorities constitute the factual basis for follow-on shareholder suits against directors and officers.[73] Shareholder litigation frequently follows a company's announcement of an investigation by enforcement agencies.[74] As former SEC Commissioner Luis A. Aguilar acutely observed,

---

66 U.S. Department of Justice, Criminal Division, Fraud Section, *Evaluation of Corporate Compliance Programs*, https://www.justice.gov/criminal-fraud/page/file/937501/download [https://perma.cc/37DB-RB9U] (last updated Aug. 16, 2017).

67 *Id.*

68 *Id.*

69 *Id.*

70 *See* Arlen & Kahan, *supra* note 45, at 334; Garrett, *supra* note 45, at 888; Mike Koehler, *Measuring the Impact of Non-Prosecution and Deferred Prosecution Agreements on Foreign Corrupt Practices Act Enforcement*, 49 U.C. DAVIS L. REV. 497, 515–27 (2015).

71 *See* Griffith, *supra* note 46, at 9–10 (2015) ("Derivative suits follow fast upon corporate mishaps and are often filed in the wake of . . . enforcement actions by regulators or prosecutors and mimic allegations made in the prior action. Claims of this type therefore have been labeled 'tag-along' derivative suits." (footnote omitted)).

72 *See, e.g.*, Westbrook, *supra* note 65, at 1228 (showing that "[t]wo dozen FCPA-related shareholder suits were filed in 2010 alone"); *see also* Griffith, *supra* note 46, at 54 (2015) (explaining how "in cases where regulators or prosecutors extract corporate governance relief in the wake of a failure of corporate compliance, as indeed they often do, shareholder litigation over the same events is fundamentally duplicative").

73 *See* Westbrook, *supra* note 65, at 1227 ("Some [shareholder] suits are triggered by disclosure of FCPA settlements with the SEC and DOJ.").

74 *See id.* ("Other shareholder suits are triggered earlier, by the announcement of a government FCPA investigation.").

directors "fulfill [their] responsibilities with the threat of lawsuits hanging over [their] head."[75] This trend is likely to intensify in the future, with every case that settles reinforcing the motivation to sue and collect ever larger amounts.[76]

The growing exposure of corporate officers and directors to liability and the rise in criminal and administrative enforcement against corporations implies that boards and corporate officers may be found responsible for the actions and omissions of their peers. As we will show in Part II, under the present legal environment, any violation of the law or breach of duty by an individual within a firm may generate adverse consequences for other organs in the firm, leaving a collective taint on their reputations and diminishing their future employability.

II
THE EXTENT AND NATURE OF DIRECTORS' AND OFFICERS' LIABILITY

In analyzing directors' and corporate officers' liability for a breach of their fiduciary duties, the first question that needs to be addressed is whether liability is assessed individually or collectively. Under an individual liability regime, each director bears legal responsibility for her actions or inactions, and failure by one director to discharge her duties does not adversely affect other directors. Under a collective liability standard, the board is considered a single, inseparable organ for liability purposes and a lapse by one board member can taint all other members.

As we will explain, the nature of directors' liability does not lend itself to simple classifications. Rather, it is highly nuanced and contextualized. In approaching this question, one first needs to distinguish between acts and omissions of the board. Insofar as acts are concerned, it is necessary to draw a second distinction between violations of the duty of care and violations of the duty of loyalty. Both Roberta Romano[77]

---

75 Luis A. Aguilar, SEC Commissioner, The Important Work of Boards of Directors, Address at the 12th Annual Boardroom Summit and Peer Exchange, New York, NY (Oct. 14, 2015).

76 *See, e.g.*, Judy Greenwald, *Multimillion-Dollar Shareholder Derivative Settlements Drive Litigation Boom*, BUS. INS. (Feb. 1, 2015), available at http://www.businessinsurance.com/article/20150201/NEWS06/302019996 [https://perma.cc/Q66S-AXYV] (noting that "multimillion-dollar settlements of shareholder derivative lawsuits are expected to lead to more litigation and even larger settlements").

77 Romano, *supra* note 38, at 1178 n.39.

and Darien Ibrahim[78] have suggested that, as a general rule, courts tend to assign collective liability in cases involving violations of the duty of care and individual liability in cases involving breaches of the duty of loyalty.

In cases of omission or oversight failure, liability is assessed collectively not only for breaches of the duty of care but also for breaches of the duty of loyalty.[79] When a board fails to detect misconduct by management, the failure, by its very nature, cannot be typically charged to a single director and the board as a whole will bear responsibility for the omission.

One may suggest that our investigation into the precise nature of directors' liability is largely theoretical since active decisions of the board fall under the business judgment rule and omissions give rise to liability only in those rare cases in which the board utterly failed to implement a reporting system or consciously ignore red flags. Hence, from a practical standpoint, the issue of directors' liability does not arise. This conclusion is erroneous.

Let us begin with the business judgment rule. At the heart of the rule lies the presumption that "in making a business decision the directors of a corporation acted on an informed basis, in good faith, and in the honest belief that the action was in the best interest of the company."[80] As long as this presumption has not been rebutted, courts will defer to the decisions of the board and corporate officers.[81] The business judgment rule insulates officers and directors from liability for a business decision made in good faith if they are not personally interested in the subject of the business judgment, are informed with respect to the subject of the business judgment to the extent they reasonably believe to be appropriate under

---

78 Ibrahim, *supra* note 37, at 935.

79 *See, e.g.*, Cottrell *ex rel.* Wal-Mart Stores, Inc. v. Duke, 829 F.3d 983, 986 (8th Cir. 2016) ("Owners of shares of Wal-Mart Stores, Inc. (Wal-Mart) sued directors and officers of the corporation, accusing them of breaking state and federal law by permitting and then covering up pervasive bribery committed on behalf of Wal-Mart's Mexican subsidiary, Wal-Mart de Mexico (Wal-Mex)."); Horman v. Abney, No. 12290-VCS 2017, Del. Ch. LEXIS 13, at *1 (Del. Ch. Jan. 19, 2017) ("Stockholders of United Parcel Service, Inc. ('UPS' or 'the Company') have brought this derivative action on behalf of the Company against members of its Board of Directors (the 'Board') alleging that they breached their fiduciary duty of loyalty by consciously failing to monitor and manage UPS's compliance with state and federal laws governing the transportation and delivery of cigarettes.").

80 *In re* Walt Disney Co. Derivative Litig., 906 A.2d 27, 52 (Del. 2006) (quoting Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984)).

81 *See id.* (stating that the board's decision will be upheld when the decision can be attributed to a rational business purpose and there is no evidence of fraud, bad faith, or self-dealing).

the circumstances, and rationally believe that the business judgment is in the best interests of the corporation.[82] The business-judgment rule protects "well-meaning directors who are misinformed, misguided, and honestly mistaken" from judicial second-guessing, except in rare case where "a transaction may be so egregious on its face that board approval cannot meet the test of business judgment."[83]

Critically, the business judgment rule only protects directors' decisions that are: (1) adequately informed; (2) made in good faith; and (3) in rational belief that they further the interest of company.[84] If one of the aforementioned elements is missing, the business judgment rule will not apply and the decision will be scrutinized under the much stricter entire fairness test. The entire fairness test requires defendants to prove that the transaction was "'entirely fair' to the corporation and its shareholders"[85] and "requires the Court to strictly scrutinize all aspects of a transaction to ensure fairness."[86] Of the three prerequisites for the application of the business judgment rule, the first—that the decision was adequately informed—has proven to be the main stumbling block for boards. *Smith v. Van Gorkom* is a case in point. As we have already discussed at length,[87] in *Smith v. Van Gorkom*, the Delaware Supreme Court ruled that the board's decision to price the shares of the target company at $55 per share was not adequately informed and thus was not entitled to the benefit of the business judgment rule.[88] *Smith v. Van Gorkom* is not the only case in which the court suspended the business judgment rule.

Cede & Co. v. Technicolor[89] is another famous decision in which the Delaware Supreme Court found that the business judgment rule does not apply to the decision of the board.[90] The facts of the case resembled those of *Van Gorkom*. In this case, Technicolor, a Delaware corporation, was acquired by MacAndrews & Forbes Group (MAF), another Delaware corporation.[91] The transaction was initiated by Fred Sullivan, a

---

82 Am. Soc'y for Testing & Materials v. Corrpro Cos., 478 F.3d 557, 572 (3d Cir. 2007).

83 FDIC v. Castetter, 184 F.3d 1040, 1046 (9th Cir. 1999); *Aronson*, 473 A.2d at 815.

84 *Am. Soc'y for Testing & Materials*, 478 F.3d at 572.

85 *In re* Walt Disney Co. Derivative Litig., 907 A.2d 693, 747 (Del. Ch. 2005).

86 RADIN, *supra* note 51, at 69.

87 *See* text accompanying notes 9–15.

88 Smith v. Van Gorkom, 488 A.2d 858, 874, 888 (Del. 1985).

89 Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 367 (Del. 1993).

90 *Id.* at 350–51.

91 *Id.* at 349.

Technicolor director, who introduced Technicolor's CEO and Chairman of the board, Morton Kamerman, to Ronald O. Perelman, MAF's Chairman and controlling shareholder.[92] For this contribution, Sullivan received a "finder's fee" of $150,000.[93] From that point on, the transaction was driven almost exclusively by Technicolor's CEO and Chairman of the Board, Morton Kamerman.[94] At the conclusion of a short meeting, Technicolor's board rubber-stamped the terms of the acquisition and gave it its blessing.[95]

Adopting the Chancery court findings,[96] the Delaware Supreme Court ruled that "all the directors had presumably breached their duty of care."[97] The Court explained that the duty of the directors to act on an informed basis is a necessary prerequisite for the application of element of the business judgment rule, and that it "requires a director, before voting on a proposed plan of merger or sale, to inform himself and his fellow directors of all material information that is reasonably available to them."[98]

There are, of course, other reported cases from Delaware and other states in which courts refused to apply the business judgment rule to board decisions.[99] It is worth noting that the question of whether the rule applies to officers' decision making has remained an open question—both in the academic literature and in case law.[100]

---

92 *Id.* at 352–53.

93 *Id.* at 355.

94 *Id.* at 355–56.

95 *Id.* at 357.

96 *Id.* at 367, 370.

97 *Id.* at 358.

98 *Id.* at 368; Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984).

99 *See e.g.,* Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 955 (Del. 1985) (explaining that in the context of anti-takeover measures, directors "must show that they had reasonable grounds for believing that a danger to corporate policy and effectiveness existed because of another person's stock ownership"); Revlon v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 182 (1986) (declining to apply the business judgment rule when dissolution of the firm was "inevitable"); Lamden v. La Jolla Shores Clubdominium Homeowners Ass'n, 21 Cal. 4th 249, 259 (1999) (applying a rule of "judicial deference to community association board decisionmaking that would apply, regardless of an association's corporate status, when owners in common interest developments seek to litigate ordinary maintenance decisions entrusted to the discretion of their associations' boards of directors," as opposed to the classic business judgment rule).

100 Amitai Aviram, *Officers' Fiduciary Duties and the Nature of Corporate Organs*, 2013 U. ILL. L. REV. 763, 765–66 (2013) (discussing this and related questions and concluding that answers to these questions depend on the classification of officers as organs or agents); *see also* Lyman P.Q. Johnson, *Corporate Officers and the Business Judgment Rule*, 60 BUS. LAW 439, 440 (2005) (arguing that the

Additionally, the scope of the business judgment rule may be influenced by extralegal forces. Interestingly, Sean Griffith has hypothesized that "in periods of scandal and crisis, corporate law judges manipulate doctrine to increase management accountability in hopes of quieting calls for federal intervention."[101] If this hypothesis is correct, then during periods of economic downturn courts may show less deference to the business judgments of corporate officers and directors.

It should also be borne in mind that many suits against corporate boards and officers ultimately settle outside of the court, despite the existence of the business judgment rule.[102] Such settlements occur because the rule does grant board decisions full and complete immunity from liability. In many cases, there is uncertainty about the applicability of the business judgment rule and litigants sometime prefer to address this uncertainty by settling.[103]

Finally, the business judgment rule does not provide boards with protection against reputational harms. And as Jonathan Macey put it, in addition to directors' concerns about their personal liability for negligence or malfeasance, directors "also are concerned about their reputations as leaders and their standing in the community. In other words, the prevailing norms of director behavior are stricter and less forgiving than the liability rules by which directors are evaluated."[104] It bears emphasis that even a ruling that gives directors the benefit of the business judgment rule may represent a dear reputational price for the directors involved.

The decision of the Delaware Court of Chancery in *In re Disney* provides a vivid illustration of this possibility. Recall that in *In re Disney*, the directors won on all counts.[105] Yet, in many ways, it was a Pyrrhic victory. The court included in its decision a scathing criticism of the directors and their behav-

---

business judgment rule does not and should not apply to officers in the same broad scope it applied to directors).

101 Sean J. Griffith, *Good Faith Business Judgment: A Theory of Rhetoric in Corporate Law Jurisprudence*, 55 DUKE L.J. 1, 57 (2005) (footnote omitted); *see also* Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV. 588, 642 (2003) (explaining that "as if positioning itself in relation to the looming federal threat, or so as not to provoke a Congress at impasse into action, Delaware hedges its bet, zigzagging between managers and shareholders").

102 *See* Griffith, *supra* note 46, at 2 (noting that "[t]he vast majority" of shareholder litigation "claims settle").

103 *Id.*

104 JONATHAN R. MACEY, CORPORATE GOVERNANCE: PROMISES KEPT, PROMISES BROKEN 52 (2008).

105 *In re* Walt Disney Co. Derivative Litig., 907 A.2d 693, 779 (Del. Ch. 2005).

ior. Chancellor William B. Chandler wrote that "many lessons of what not to do can be learned from the defendants' conduct,"[106] and expressed hope "that this case will serve to inform stockholders, directors and officers of how the Company's fiduciaries underperformed."[107] Furthermore, the Chancellor included in the decision evidence suggesting that several of the defendants lacked the competency to serve as directors.[108] In an age in which court decisions are carefully monitored, documented and scrutinized by the media, such statements continue to reverberate for a long time and can change the fortunes of individual directors. It should be added in this vein that there is a growing tendency among courts to criticize boards and corporate officers.[109]

Now turn to oversight liability. Under Delaware caselaw, directors may be liable for a breach of the duty of loyalty if they fail, in bad faith, to implement an information reporting system mechanism within the firm, or monitor the information flows therein.[110] Oversight liability has been dubbed by the Delaware Court of Chancery as "possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment."[111] The doctrine of oversight liability originated in the case of *In re Caremark Litigation Inc. Derivative Litigation*.[112] The case arose from an investigation launched by the DOJ into Caremark's practice of paying doctors in exchange for referrals.[113] Caremark ultimately agreed to pay approximately $250 million to settle the case.[114] The Delaware Court of Chancery approved the settlement.[115] En route to this result, Chancellor Allen opined that "only a sustained or systematic failure of the board to exercise oversight—such as an utter failure to attempt to assure a reasonable information and reporting system exits—will establish the lack of good faith that is a necessary condition to liability."[116]

---

106 *Id.* at 760.
107 *Id.* at 772.
108 *See id.* at 761 & n.488.
109 *See generally* David A. Skeel, Jr., *Shaming in Corporate Law*, 149 U. PA. L. REV. 1811, 1832–57 (2001) (discussing the growing use of court opinions written to "shame" corporate managers and directors).
110 *In re* Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 971 (Del. Ch. 1996).
111 *Id.* at 967.
112 *Id.* at 970.
113 *Id.* at 963.
114 *Id.* at 960–61.
115 *Id.* at 959, 972.
116 *Id.* at 971.

A decade later, the Delaware Supreme Court refined the standard of liability in *Stone v. Ritter*.[117] In *Stone*, the shareholders of the AmSouth Bancorporation brought a derivative suit against the directors of the company, alleging that they failed to detect various violations of the federal Bank Secrecy Act and various anti-money-laundering regulations by company employees that triggered a $50 million fine.[118] The Chancery Court refused to impose liability on the directors based on *Caremark*.[119] On appeal, the Delaware Supreme Court affirmed.[120] It added that liability for oversight will arise only in cases of utter failure on the part of the board to ensure the existence of information-reporting systems or if the board consciously elected to ignore red flags that were brought to its attention.[121] Under Delaware law, therefore, plaintiffs who bring oversight claims face an uphill battle.

Yet, it is a mistake to assume that directors are immune from oversight claims. In *In re Countrywide Financial Corporation Derivative Litigation*, the court suggested the failure to observe and address flagrant and repeated violations of underwriting standards in the presence of firm-specific red flags by several directors who served on important committees on the company, may support a finding of scienter or deliberate recklessness.[122] Although the suit was subsequently dismissed for lack of standing,[123] it suggests that oversight claims may succeed in the future. In the context of oversight liability, too, it is important to be mindful of the reputational harm to directors.

More importantly, the discussion so far ignores a critical legal risk against which neither the business judgment rule nor the stringent requirements of oversight liability protects directors: enforcement actions by the DOJ, SEC, and other administrative agencies. Once the DOJ or the SEC launches an investigation against a certain company, a cloud of suspicion immediately hangs over the heads of the members of board. Investigations of corporate wrongdoing take years to complete. In 2016, the median duration of FCPA enforcement actions was

---

117 *See* Stone *ex rel.* AmSouth Bancorporation v. Ritter, 911 A.2d 362 (Del. 2006).

118 *Id.* at 365.

119 *Id.* at 364–65.

120 *Id.* at 365.

121 *Id.* at 370.

122 *In re* Countrywide Fin. Corp. Derivative Litig., 554 F. Supp. 2d 1044, 1062–64 (C.D. Cal. 2008).

123 *Id.* at 1083.

4.25 years,[124] and according to the General Accounting Office report the investigation of certain FCPA violations "could take up to 10 years."[125] While an investigation against a company is ongoing, the directors must live with the negative repercussions that accompany enforcement actions and can do very little to dispel the legal uncertainty that shrouds them.

But this is just the beginning of the directors' and corporate officers' legal Via Dolorosa. Most of the DOJ and SEC investigations lead to pretrial diversion agreements, under which a corporation admits to certain counts of wrongdoing in exchange for the payment of a penalty and a promise to implement corrective measures to prevent recidivism.[126] Critically, for our purposes, such agreements treat board misdeeds as collective failures. Enforcement agencies are not interested in apportioning individual blame; rather, they focus on whether or not a corporation broke the law.[127] Determinations of individual liability fall beyond the purview of the investigation and are considered a waste of public resources.[128] Enforcement authorities do not award citations to individual directors who acted diligently and do not bother to exculpate them.

Moreover, the corporations against whom the investigation is carried out are eager to see it through and they too are uninterested in clearing individual directors of allegations of wrongdoing. Pretrial diversion agreements typically contain a clause stating that the company involved accepts responsibility "for the acts of its officers, directors, employees and agents as charged."[129] Similarly, public reports of the company in-

---

124 *The Gray Cloud of FCPA Scrutiny Lasted Too Long In 2016*, FCPA PROFESSOR (Jan. 6, 2017), http://fcpaprofessor.com/gray-cloud-fcpa-scrutiny-lasted-long-2016/ [https://perma.cc/B9SW-CB28].

125 U.S. GOV'T ACCOUNTABILITY OFF., GAO-09-636T, CORPORATE CRIME: PRELIMINARY OBSERVATIONS ON DOJ'S USE AND OVERSIGHT OF DEFERRED PROSECUTION AND NON-PROSECUTION AGREEMENTS 9 (June 25, 2009).

126 Koehler, *supra* note 70.

127 *Id.* at 530 ("Despite such rhetoric, there is a wide gap between FCPA enforcement against business organizations and enforcement against individuals employed by the entity resolving the corporate action."). Koehler also demonstrates how "since the DOJ first used an alternative resolution vehicle in December 2004 to resolve an FCPA enforcement action against a business organization, there have been 84 criminal FCPA enforcement actions against business organizations . . . [however] 76% [of them] did not involve any related criminal prosecution of company employees." *Id.* at 538.

128 *Id.*

129 *See, e.g.*, Deferred Prosecution Agreement at ¶2, United States v. Och-Ziff Capital Mgmt. Group LLC, No. 16-CR-00516 (E.D.N.Y. Sept. 27, 2016), https://www.justice.gov/opa/file/899306/download [https://perma.cc/NRX6-KBA9] (including clause that no employee, officer, or agent will contradict acceptance of responsibility); United States v. Lloyds Banking Group PLC, Deferred Prosecution

volved—such as annual, quarterly, and current reports—also state that the DOJ or the SEC are now conducting an investigation into the activities of the corporation, without offering further details as to the identity of the individuals (managers or directors) involved.[130] In other words, the corporation and its organs become an inseparable whole. Hence, enforcement actions leave a collective indelible taint on the board as a whole, which in turn diminishes its members' prospect of being reelected.

Agreement (July 28, 2014), https://www.justice.gov/criminal-fraud/file/836371/download [https://perma.cc/GZ38-ENV4] (including similar clause detailing company's liability for all agents); United States v. Deutsche Bank AG, Deferred Prosecution Agreement ¶ 2 (Apr. 23, 2015), https://www.justice.gov/sites/default/files/criminal-fraud/legacy/2015/05/22/2014-04-23-deutsche-bank-deferred-prosecution-agreement.pdf [https://perma.cc/XW7Q-TVGD] (including similar clause); United States v. HSBC Bank USA, N.A. and HSBC Holdings PLC, Deferred Prosecution Agreement ¶ 2 (Dec. 10, 2012), https://www.sec.gov/Archives/edgar/data/83246/000119312512499980/d453978dex101.htm [https://perma.cc/57AU-L2WB] (including similar clause).

130 *See, e.g.*, KBR, Inc., Quarterly Report (Form 10-Q) (Oct. 31, 2008), https://www.sec.gov/Archives/edgar/data/1357615/000114036108024084/form10-q.htm [https://perma.cc/YX82-8QSP] ("The SEC is conducting a formal investigation into whether improper payments were made to government officials in Nigeria through the use of agents or subcontractors in connection with the construction and subsequent expansion by TSKJ of a multibillion dollar natural gas liquefaction complex and related facilities at Bonny Island in Rivers State, Nigeria. The DOJ is also conducting a related criminal investigation."); Och-Ziff Capital Management Group LLC, Annual Report (Form 10-K) (Nov. 2, 2016), https://www.sec.gov/Archives/edgar/data/1403256/000140325616000197/0001403256-16-000197-index.htm [https://perma.cc/KN7P-NN55]

> Since 2011, the Company has been investigated by the Securities and Exchange Commission (the 'SEC') and the U.S. Department of Justice (the 'DOJ') concerning possible violations of the Foreign Corrupt Practices Act (the 'FCPA') and other laws. The investigation concerns an investment by a foreign sovereign wealth fund in some of the Och-Ziff funds in 2007 and investments by some of the funds, both directly and indirectly, in a number of companies in Africa. While the Company is unable to predict the full scope, duration or outcome of the SEC and DOJ investigation, it believes that it is reasonably likely that the outcome would include the government pursuing remedies. The Company expects to enter into discussions to resolve any actions that may arise out of the investigation at the appropriate time in the future. The SEC and DOJ have a broad range of civil and criminal sanctions available to them under the FCPA and other laws. The Company is currently unable to estimate the range of possible loss. While the ultimate impact of any sanctions that may arise cannot be estimated at this time, any such resolution could have a material adverse effect on the Company's business and its consolidated financial statements.

III
UNPACKING FIRMS

Corporations are often viewed as collective legal entities, comprised of various organs. The organs, primarily the management and board of directors, chart the course for the corporation, manage its affairs, and supervise its operations. Corporate organs, however, consist of individuals with divergent backgrounds, expertise, and personalities. The decisions made by corporate organs are the product of their interactions and the resulting dynamics. Unsurprisingly, the ability of certain individuals to affect outcomes and shape corporate policies is far greater than others. And, while all corporate officers and directors are responsible for the fortunes of the firm, credit and blame often should not be equally apportioned.

In this Part, we examine how the individual composition of corporate organs affects decision making processes within firms. We turn to the caselaw to demonstrate how differences in expertise, skills, and personalities shape policies within the firm. Then, we unveil the challenge faced by directors and officers who disagree with their peers. In this respect, we show that dissenting corporate officers and directors have built in incentives to align themselves with the majority.

A. Individual and Collective Decision Making

Independent thinking by directors and corporate officers is believed to improve the quality of the decisions made within a firm.[131] In keeping with this belief, the number of independent directors on public company boards has risen exponentially over the last few decades.[132] Yet, in reality, independence is an elusive goal. As we will show in this subsection, the dynamics of collective decison-making processes exert substantial pressure on directors to conform. We will then demonstrate that the dynamics that characterize interactions among directors also apply to other corporate officers, albeit to a lesser extent.

---

[131] *See* Michael Useem, *How Well-Run Boards Make Decisions*, HARV. BUS. REV. (Nov. 2006) https://hbr.org/2006/11/how-well-run-boards-make-decisions [https://perma.cc/GLJ4-BKY5].

[132] *See* Jeffrey N. Gordon, *The Rise of Independent Directors in the United States, 1950-2005: Of Shareholder Value and Stock Market Prices*, 59 STAN. L. REV. 1465, 1475 (2007) (reporting that the percentage of independent directors on the boards of large public companies has risen from 20% in 1950 to 75% in 2005).

1. *Directors*

The board of directors is typically viewed as a collective entity.[133] Court decisions and academic articles alike often refer to the board as a single, monolithic organ tasked with performing certain duties for the shareholders.[134] Similarly, the performance of the board is often assessed on a collective basis; the individual members of the board often do not receive separate discussion.[135] The success of a board is attributed to all its members indiscriminately and all members bear responsibility collectively in cases of failure.[136] Unfortunately, this view ignores the reality of boards.

Boards are comprised of individuals, who widely diverge in their skillsets, professional experiences, and personalities. As Adams, Hermalin, and Weisbach have correctly observed, "[e]ach board of directors is likely to have its own dynamics, a function of many factors including the personalities and relationships among the directors, their backgrounds and skills, and their incentives and connections."[137] These differences among directors have profound impact on the operation of boards. Although, formally, all directors have equal powers and equal responsibilities, members with unique expertise in matters that are brought before the board or who possess superior information about them, naturally carry a lot more weight in board discussions and exert disproportionate influence on board decisions. In the proceeding paragraphs we will substantiate our claim that boards are not monolithic entities, but rather human amalgams consisting of diverse individuals with complementary skills. We will then elaborate on the reasons that make certain directors carry disproportionate weight on the board in particular settings and analyze the risk such cases present to other directors by reviewing cases in which this risk materialized.

---

133 *See, e.g.*, Smith v. Van Gorkom, 488 A.2d 858, 874 (Del. 1985) (reaching conclusion about "the Board of Directors" as a whole).

134 *Id.*

135 *See id.* (assessing the collective behavior of "[t]he directors" as opposed to individual directors.).

136 *Id.*

137 Renée B. Adams, Benjamin E. Hermalin & Michael S. Weisbach, *The Role of Boards of Directors in Corporate Governance: A Conceptual Framework and Survey*, 48 J. ECON. LITERATURE 58, 81 (2010).

a. *Different Skill Sets*

Expertise and experience are the principal criteria by which board members are selected.[138] Directors with divergent skill sets and experiences can dramatically improve the functioning of the board and the company as a whole.[139] Insofar as skill sets are concerned, it is customary to distinguish between financial and legal expertise.[140] Naturally, directors with extensive experience in finance or investment banking will invariably be given deference in decisions pertaining to corporate finance, merger and acquisitions, and other deals that require finance-oriented thinking.[141] Similarly, directors with legal training will play a more dominant role when a company faces a legal challenge.[142] Of course, in many companies the breakdown goes beyond financial and legal expertise. For example, expertise in accounting is distinguishable from financial acumen and is valued in its own right.[143] Likewise, legal expertise can be divided into subspecializations, such as corporate governance and modern compliance. Moreover, directors often have industry specific expertise.[144] For example, in pharmaceutical companies, there will be board members who are intimately familiar with the pharmaceutical industry and its intricacies. The same is true for corporations operating in other sectors of the economy.

---

138 *See, e.g.*, Keren Bar-Hava, Feng Gu, & Baruch Lev, *The Virtues of Fewer Directorships* 9 (Maastricht University Graduate School of Business and Economics, Research Memorandum No. 037, 2013) (describing an "increased demand for qualified, experienced directors").

139 *See, e.g.*, Baysinger & Butler, *supra* note 32, at 121 (noting that "the most appropriate board composition, although variable from firm to firm in response to differing circumstances, includes a mixture of various types of directors"); *see also* Julie Hembrock Daum, *Building a Balanced Board*, SPENCERSTUART 72–73 (Feb. 2015), https://www.spencerstuart.com/research-and-insight/building-a-balanced-board [https://perma.cc/3BV9-MUY9] (pointing out that "boards with a good mix of age, experience, and backgrounds tend to foster better debate and decision-making and less groupthink").

140 *See* Baysinger & Butler, *supra* note 32, at 112 (distinguishing between "financiers" and "lawyers," among many other categories of directors).

141 *See* Adams, Hermalin & Weisbach, *supra* note 137, at 83 (explaining that firms add bankers to their boards because bankers "can provide financial expertise").

142 *See* Cassandra D. Marshall, Are Dissenting Directors Rewarded? (Aug. 28, 2010) (unpublished Ph.D. dissertation, Indiana University) https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1668642 [https://perma.cc/5XSW-ZBEF].

143 Adams, Hermalin & Weisbach, *supra* note 137, at 83.

144 *See* Bar-Hava, Gu & Lev, *supra* note 138, at 1 (noting that the court scrutinized directors' expertise under regulations such as Sarbanes-Oxley).

Reliance on expertise and deference to knowledge are not problematic per se. On the contrary, it often the key to success. As Jill Fisch astutely noted, in the modern business world "[b]oards that include directors with technical expertise, industry background, or experience in comparable business issues, provide a CEO with a team of experts . . . [whose] input can enhance corporate decisionmaking and prevent costly mistakes."[145] But there is also an obvious downside to deference to expertise: when the expert-director errs in her judgment or, worse, acts in bad faith or in a conflict of interest that is not disclosed to the board, she can lead the entire board astray. In such cases, the misjudgment may expose all board members to liability. For example, in *Smith v. Van Gorkom*, the merger transaction was architected by Van Gorkom, who had extensive experience in mergers and acquisitions. As the Delaware Supreme Court explained, "[h]e was familiar with acquisition procedures, valuation methods, and negotiations; and he privately considered the pros and cons of whether Trans Union should seek a privately or publicly-held purchaser."[146] He was also the one who determined the price at which the Trans Union shares would be tendered.[147] The other directors deferred to Van Gorkom's judgment.[148] Indeed, Van Gorkom's experience in the field of finance clothed his judgment with an air of inviolability—at least in the eyes of the other board members.[149]

Similarly, in a recent Delaware case several AIG board members hatched an elaborate financial scheme involving "secret offshore subsidiaries to mask AIG losses."[150] The case involved board members Maurice R. Greenberg, the CEO and Chairman of the board, and Edward E. Matthews, who served on AIG's board for almost thirty years, was Vice Chairman of Investments and Financial Services, and was described by the court as "deeply sophisticated in financial investments, and, due to his lengthy experience with AIG's insurance operations, privy to and involved in financial investment strategies and

145 Jill E. Fisch, *Taking Boards Seriously*, 19 CARDOZO L. REV. 265, 285–86 (1997).
146 Smith v. Van Gorkom, 488 A.2d 858, 866 (1985).
147 *Id.*
148 *Id.* at 869.
149 *See* Jonathan R. Macey, *Smith v. Van Gorkom: Insights About C.E.O.s, Corporate Law Rules, and the Jurisdictional Competition for Corporate Charters*, 96 NW U. L. REV. 607, 618 (2002) (suggesting that "the board erred in placing too much trust" in Van Gorkom").
150 *In re* Am. Int'l Grp., Inc. Consol. Derivative Litig., 965 A.2d 763, 775 (Del. Ch. 2009).

product developments that were innovative, risky in nature, or sizable in scope."[151] As the Court of Chancery pointed out, the other board members were blindsided by the deviant plan of Greenberg and his cronies because "Greenberg and the Inner Circle Defendants employed their expertise in illicit ways that ultimately resulted in billions of dollars of harm to AIG."[152] Given the financial complexity of the cover up scheme, it is not surprising that the other board members did not challenge it and later on were dragged into "the flurry of inquiries."[153]

Finally, in the Enron litigation, the poster child of corporate law gone wrong, the company made use of a dubious accounting method known as "mark-to-market" in order to inflate the value of the company.[154] Enron also engaged in a variety of cover-up tactics intended to hide losses and fabricate earnings, via the creation of, for example, multiple special purpose entities.[155] Behind this culture of corporate corruption were Enron's Chief Operating Officer (and later CEO), Jeffrey Skilling, its Chief Financial Officer, Andrew Fastow, and the Chairman and CEO of Enron, Kenneth Lay.[156] Of the three, Skilling was the one who transformed the culture at Enron—for better and worse.[157] Skilling was "the man widely viewed as the brains behind Enron's rise."[158] He was an ardent believer in non-traditional evaluation methods and divided the world into "those who 'got it' and those who didn't."[159] Naturally, almost everyone wanted to be in the former group; none desired to belong to the latter.[160] Skilling's track-record, experience, and business philosophy made him a force within Enron. The en-

---

151 *Id.* at 796.

152 *Id.* at 777.

153 Kurt Eichenwald & Jenny Anderson, *How a Titan of Insurance Ran Afoul of the Government*, N.Y. TIMES (Apr. 4, 2005), https://www.nytimes.com/2005/04/04/business/how-a-titan-of-insurance-ran-afoul-of-the-government.html [https://perma.cc/NV67-U8ER].

154 Milton C. Regan, Jr., *Teaching Enron*, 74 FORDHAM L. REV. 1139, 1145–46 (2005).

155 *Id.*

156 *Id.* at 1144, 1202.

157 *See id.* at 1146–49 (describing Skilling's role in shaping the company's "entrepreneurial ethos").

158 Kurt Eichenwald, *Enron Founder, Awaiting Prison, Dies in Colorado*, N.Y. TIMES (July 6, 2006), http://www.nytimes.com/2006/07/06/business/06enron.html [https://perma.cc/CZ6B-TWRU].

159 BETHANY MCLEAN & PETER ELKIND, THE SMARTEST GUYS IN THE ROOM: THE AMAZING RISE AND SCANDALOUS FALL OF ENRON 233 (2003).

160 Regan, *supra* note 154, at 1146.

tire company, including the management and the board, were spellbound by him.[161]

b. *Different Roles and Positions on the Corporation*

Many board members also serve in key positions for the corporations they guide and monitor. It is not unusual for the CEO of a company to hold a board position or even serve as the chairperson of the board.[162] In 2016, 52% of companies in the S&P 500 Index were led by a dual Chairman/CEO.[163] Similarly, other board members often occupy managerial positions and are in charge of various committees, such as the executive, audit, risk, finance, and compensation committees.[164] In their capacity as officers, individual members are exposed to data and analysis that are not available to other board members. Likewise, they engage in meetings and interactions with third parties in which their peers on the board do not partake. Unsurprisingly, a board member who is privy to negotiations with a third party might become the dominant voice in board discussions concerning the desirability of the deal.

Recall that in *In re Disney*, the terms of Ovitz's extravagant compensation package were designed by Irwin Russell, a board member, who also chaired Disney's compensation committee.[165] As chairman of the compensation committee, Russell was "familiar with the Company's compensation policies and practices."[166] Naturally, he "assumed the lead role in negotiating the financial terms of [Ovitz's] contract,"[167] which, in turn, made him "privy to a great deal of information with respect to Ovitz."[168] Russell's opinion thus carried a lot of weight with his peers on the board. In justifying the unusual compensation

---

161 O'Connor, *supra* note 33, at 1264 (discussing the respect Skilling commanded at Enron and describing the "cult" culture he inculcated); *see also* S. REP. NO. 107-70 at 8 (2002) [hereinafter *Enron Report*]; LEONARD J. BROOKS & PAUL DUNN, BUSINESS & PROFESSIONAL ETHICS FOR DIRECTORS, EXECUTIVES & ACCOUNTANTS 644 (6th ed. 2012) ("All [directors] indicated they had possessed great respect for senior Enron officers, trusting the integrity and competence of Mr. Lay . . . Jeffrey K. Skilling . . . Andrew S. Fastow. . . .").

162 *See* Adams, Hermalin & Weisbach, *supra* note 137, at 81 (exploring the "CEO-Chairman Duality").

163 SPENCER STUART, 2016 SPENCER STUART BOARD INDEX: A PERSPECTIVE ON U.S. BOARDS 8, 23 (2016) https://www.spencerstuart.com/~/media/pdf%20files/research%20and%20insight%20pdfs/spencer-stuart-us-board-index-2016_july2017.pdf [https://perma.cc/79EH-XW6C].

164 Of course, the importance of different committees may vary among firms.

165 *In re* Walt Disney Co. Derivative Litig., 907 A.2d 693, 702 (Del. Ch. 2005).

166 *Id.* at 763.

167 *Id.* at 702.

168 *Id.* at 764.

promised to Ovitz, Russell reportedly explained that Ovitz "was an 'exceptional corporate executive' who was a 'highly successful and unique entrepreneur.'"[169] Given the ringing endorsement of the chairman of the compensation committee, who was intimately familiar with the details of the transaction, and the unwavering support of Disney's chairman and CEO (at the time), Michael Eisner, it is little wonder that none of the other directors went out of their way to oppose the hire or the terms of his contract.[170]

Informed board members can affect the fortunes of their uninformed colleagues in yet another way: instead of relying on the superior information they hold to bolster their position in board meetings, they can go in the opposite direction and influence board decisions by suppressing information from their colleagues. An illustration of this strategy can be found in the case of *Saito v. McCall*.[171] The lawsuit grew out of a problematic merger between two companies, McKesson and HBOC.[172] The plaintiffs claimed that the board and senior officers of HBOC "presided over a fraudulent accounting scheme,"[173] and that McKesson's board and officers learned of the problem during the due diligence process, but chose to ignore it.[174] The plaintiffs further argued that after the merger the board of the merged company did not act expeditiously enough to address the problem.[175] Three of HBOC's directors who served on the audit committee of the company, as well as its CEO and chairperson of the board, Charles McCall, were fully aware of the accounting scheme.[176] The remaining directors tried to argue that unlike their informed peers who were familiar with the fraudulent accounting practice by virtue of their other positions, they had no knowledge of the problem as it was never brought to their attention.[177] The Chancery court rejected their claim, ruling that "[a] reasonable inference, which the Court is entitled to draw at this procedural stage, is that [the] information was communicated to the other HBOC board members who later served on McKesson HBOC's board."[178]

169 *Id.* at 704 (footnote omitted).
170 *Id.* at 710.
171 No. CIV.A. 17132-NC, 2004 WL 3029876 (Del. Ch. Dec. 20, 2004).
172 *Id.* at *1.
173 *Id.*
174 *Id.* at *3–4.
175 *Id.* at *4.
176 *Id.* at *3.
177 *Id.*
178 *Id.* at *7, n.68.

The court proceeded to reject the directors' motion to dismiss on this count.[179]

c. *Different Personalities*

Finally, as is true in all groups, certain members of boards of directors have a more dominant personality than others. Steven Davidoff has suggested that personalities and egos account for many of the transactions that shaped corporate America.[180] The same is true for board decisions. On every board, there will be strong-minded members who assert their views more forcefully than others. Naturally, such board members are likely to be more dominant in board meetings and their opinions will carry more weight when disagreement arises. It should be noted that directors with dominant personalities are also more likely to serve in key corporate positions, which further accentuates their innate air of authority. Examples are legion.

Begin with Jeffrey Skilling, Enron's CEO who also served as a director.[181] Skilling reportedly inculcated a "cult-like" culture within the firm.[182] He was admired and feared by those who interacted with him and almost no one wished to challenge him.[183] Thus, it should come as no surprise that, as the Enron directors reported to the Senate, "Board votes were generally unanimous" and directors "could recall only two instances over the course of many years involving dissenting votes."[184] Next, recall Michael Eisner, from Disney. Eisner served as the company's chairperson and CEO.[185] According to testimonies at the trial, Eisner disliked dissention and "desire[d] to surround himself with yes men."[186] Similarly, Maurice Greenberg, the chairperson of the board and CEO of AIG, created around him an inner circle of confidants whom he showered with rewards.[187] In addition, Greenberg was involved in the nitty-

---

179 *Id.* at *7.

180 *See* STEVEN M. DAVIDOFF, GODS AT WAR: SHOTGUN TAKEOVERS, GOVERNMENT BY DEAL, AND THE PRIVATE EQUITY IMPLOSION (2009).

181 O'Connor, *supra* note 33, at 1236 n.19, 1256.

182 *Id.* at 1264 (quoting Joe Stephens & Peter Behr, *Enron's Culture Fed its Demise*, WASH. POST, Jan. 27, 2002, at A01).

183 *Id.*

184 *Enron Report*, *supra* note 161, at 8.

185 *In re* Walt Disney Co. Derivative Litig., 907 A.2d 693, 699 (Del. Ch. 2005).

186 *Id.* at 761 n.488.

187 *See In re* Am. Int'l Grp. Inc. Consol. Derivative Litig., 965 A.2d 763, 781 (Del. Ch. 2009) ("Greenberg could, at his sole discretion, award tens of millions of dollars to members of his Inner Circle who stayed in his good graces.").

gritty of the company.[188] Greenberg was perceived as a dominant and omniscient figure.[189] According to the Delaware Court of Chancery, "[h]is domination even extended to the board that was supposed to be overseeing Greenberg and the rest of AIG's management. AIG's directors were allegedly so in Greenberg's thrall that they avoided asking questions around him lest they seem ignorant."[190]

Another famous example is Angelo R. Mozilo from *Countrywide Financial Corp.* Countrywide, one of the nation's leading mortgage lenders, who together with many of its directors and officers, was found liable for issuing risky non-conforming loans that drove the company to the verge of bankruptcy.[191] Mozilo, who received the dubious title "the face of the financial crisis,"[192] was the founder of Countrywide.[193] He also chaired the company's board of directors and acted as its CEO.[194] Mozilo has been described as a person with "a desperate hunger to be No. 1, which led Countrywide into a race to the bottom as the mortgage market spiraled out of control."[195] He infected the company with a corporate culture known as "the tyranny of goals" and a "cult of personality."[196]

In sum, the personality traits of certain directors and the way they carry themselves around others are formative forces that can transform decision making processes on boards. This is especially true when the same directors who bring a strong personality to the board room, also serve on other key positions on the corporation and have served on the board for a long time. Such directors are likely to have a disproportionate impact on the decision of the board. As we show next, individual directors who wish to oppose them face an uphill battle.

---

188 *See id.* at 780–81 ("Not only did Greenberg run the company, he allegedly knew everything that went on within it.").

189 As one executive colorfully described it, "[i]f a twig snaps in a Chinese forest, Maurice Greenberg hears it." *Id.* at 781.

190 *Id.* at 781.

191 *In re* Countrywide Fin. Corp. Derivative Litig., 554 F. Supp. 2d 1044, 1068 (C.D. Cal. 2008).

192 Connie Bruck, *Angelo's Ashes: The Man Who Became the Face of the Financial Crisis*, NEW YORKER (June 29, 2009), at 46, https://www.newyorker.com/magazine/2009/06/29/angelos-ashes [https://perma.cc/5TGV-SYET].

193 John R. Emshwiller & Kara Scannell, *Mozilo Agrees to Pay $67.5 Million*, WALL ST. J. (Oct. 16, 2010), at 31, https://www.wsj.com/articles/SB10001424052748704300604575554321099510704 [https://perma.cc/8W9C-DLSF].

194 *Countrywide*, 554 F. Supp. 2d at 1049.

195 DAVID E. MCCLEAN, WALL STREET, REFORMING THE UNREFORMABLE: AN ETHICAL PERSPECTIVE 74 (2015).

196 *Id.*

2. *Corporate Officers*

Corporate officers differ from directors in two important respects: first, they possess the requisite expertise to perform their corporate roles. As Melvin Eisenberg put it:

> Unlike other professionals, directors, acting in that capacity, are usually generalists. . . . In contrast to directors, officers usually are expected to have special competence and skill—the competence and skill of managers, and, if they hold a specialized position (such as a finance post), the competence and skill necessary for that position.[197]

Second, officers are not required to make decisions collectively.[198] To be sure, they must abide by the policies adopted by the board, but they typically act on their own. Hence, corporate officers are largely protected from the pressures faced by individual directors.

Nonetheless, there is an element of interdependence even among corporate officers. Each officer must rely on informational inputs she receives from her peers. Even an accomplished CEO cannot be expected to do well on her job without accurate legal advice and the full cooperation of other organs. Likewise, other office holders critically depend on the information and instructions they receive from the firm's CEO and upper management. Firms, after all, are hierarchical in nature.[199] Therefore, ensuring a system of trust throughout the firm is of paramount importance.

It should be noted in this regard that the performance of boards is largely a function of the nature of their relationship with other executives. Former SEC Commissioner Bevis Longstreth has opined that "[t]he cause of board failures is typically their capture by executives."[200] The problem of capture is an

---

197 Melvin A. Eisenberg, *The Duty of Care of Corporate Directors and Officers*, 51 U. PITT. L. REV. 945, 951 (1990).

198 Officers are not required to make a collective decision. This is in contrast to directors that must make a collective decision, often by voting on the matter. *See, e.g.*, Nadya Malenko, *Communication and Decision-Making in Corporate Boards*, 27 REV. FIN. STUD. 1486, 1486 (2014) ("The board of directors is a collective body. . . ."); *see also id.* at 1488 ("At the decision-making stage, all directors take actions (e.g., vote) based on their private information and the information inferred from the discussion, and the board's collective decision is made.").

199 *See* R.H. Coase, *The Nature of the Firm*, 4 ECONOMICA 386, 403 (1937) (demonstrating how "[w]e can best approach the question of what constitutes a firm in practice by considering the legal relationship normally called that of 'master and servant' or 'employer and employee'").

200 Bevis Longstreth, *Boards Fail When Executives Are Captured*, FIN. TIMES (Feb. 12, 2016), https://www.ft.com/content/8dc26bb4-cf1a-11e5-92a1-c5e23ef99c77 [https://perma.cc/VB7E-BDMJ].

intricate one and it lies beyond the scope of this Article. However, as a matter of policy, the law should ensure that executives do not manipulate boards illicitly by negligently providing them with inaccurate factual information and analysis or concealing conflicts of interest.[201]

B. The Plight of Individual Directors and Corporate Officers

The two strategies individual board members and corporate officers have at their disposal are "voice" and "exit."[202] The voice option refers to the ability of an individual director or officer to express her opinion about the way a company is managed and exercise her voting rights on the different matters brought before her.[203] The exit option consists of the power to resign from one's position; it will be exercised when an individual director or officer believes that the policies adopted by her are ruinous to the company or that she can no longer perform the duties expected of her.[204]

Board decisions reflect the interaction among the individual directors and are ultimately produced via a collective decision mechanism—namely, voting. It should be understood, though, that collegiality norms exert constant pressure on individual members to conform or cooperate with the other members of the board, and not dissent.[205] It must be born in mind that directors interact on an ongoing basis. Consequently, a director who elects not to support her colleagues on a certain matter runs the risk of future retaliation, consistent with the "tit-for-tat" strategy, the dominant strategy in games with re-

---

201 The defense stipulated in section 141(e) of the Delaware General Corporation Law that exculpates from liability directors or officers who relied in good faith on the representations of their peers or other committee members is consistent with our call. DEL. CODE ANN. tit. 8, § 141(e) (2016). However, it is difficult to prove good faith in this context.

202 ALBERT O. HIRSCHMAN, EXIT, VOICE, AND LOYALTY 4 (1970).

203 *Id.*

204 *Id.*

205 LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION 32 (2004) ("[E]xcept perhaps in times of crisis, the members of the board are expected to act collegially toward one another. According to a director who has served on the boards of several public companies, including Marriott Corporation, 'It is hard to explain to a person who is not a director. *It is in many ways a club.*' While each board may have slightly different social rules, these norms tend to foster board cohesion." (emphasis added) (footnote omitted)).

peated iterations.[206] Furthermore, because votes are decided by the majority, dissension may earn a director the scorn of her colleagues while yielding her no benefit whatsoever in terms of charting the future course of the company. Finally, from a pure legal standpoint, raising objections, voting against board resolution, and even resigning one's post on the board does not guarantee individual directors immunity from liability.[207]

1. *Voice*

Voice is the predominant tool of board members. Directors are expected to inquire about corporate policies and managerial decisions, criticize them when necessary, and vote against them if they do not deem them beneficial for the company.[208] In theory, board members are at complete liberty to criticize and dissent, but in reality directors often face strong pressure to conform and cooperate.[209] To see why, it is necessary to take a closer look at how boards are structured and operate.

Begin with the way boards are being set up. Board members are not chosen arbitrarily. They are carefully selected, first and foremost, based on skill and experience, but also based on personality.[210] While corporations may not necessarily want their boards to be populated by yes-men, who act as human rubberstamps, they are likely to be far more disinclined to hire professional neighsayers, who raise decision making

206 *See* Paul G. Mahoney & Chris William Sanchirico, *Norms, Repeated Games, and the Role of Law*, 91 CALIF. L. REV. 1281, 1291–95 (2003) (discussing tit-for-tat strategy).

207 *Infra* notes 226–38.

208 *See* Bainbridge, *supra* note 34, at 8 ("[I]ndividual board members provide advice and guidance to top managers with respect to operational and/or policy decisions.").

209 *See, e.g.*, MICHAEL C. JENSEN, A THEORY OF THE FIRM: GOVERNANCE, RESIDUAL CLAIMS, AND ORGANIZATIONAL FORMS 50 (2000) (describing CEOs' tendency to "reward[] consent and discourag[e] conflict" among board members as a "continuing cycle of ineffectiveness"); *see also* Bainbridge, *supra* note 34, at 32 (noting that "[b]oardroom culture encourages groupthink. Boards emphasize politeness and courtesy at the expense of oversight"); Donald C. Langevoort, *The Human Nature of Corporate Boards: Law, Norms, and the Unintended Consequences of Independence and Accountability*, 89 GEO. L.J. 797, 810–11 (2001) (arguing that the psychological influence of small groups leads to "groupthink" and censorship); O'Connor, *supra* note 33, at 1261–69 (identifying the three antecedent conditions for groupthink as cohesiveness, structural faults in a group's decision making process, and the need to make consequential decisions during a time of high stress).

210 *See* James D. Cox & Harry L. Munsinger, *Bias in the Boardroom: Psychological Foundations and Legal Implications of Corporate Cohesion*, 48 LAW & CONTEMP. PROBS. 83, 91 (1985) ("[T]he board nominee's personality should be compatible with that of the current directors.").

and operation costs.[211] From a personality standpoint, corporations would prefer to hire reasonable people who are perceived as team players.[212] Understanding this, board candidates, for their part, have an inherent incentive to adopt a cooperative posture when interviewing for a board position and to not act in an obstructionist manner after they are appointed.[213]

In this vein, it should be noted that leading commentators have advanced a far bleaker view of directors' selection and appointment. The conventional wisdom among corporate scholars suggests that directors play a pivotal role in appointing their peers.[214] Dissenting directors, therefore, face the risk of not being reelected. Aware of this fact, directors who wish to be reelected—a desire most directors are presumed to have[215]—will strive not to cross their peers or even upset them. Furthermore, dissention also diminishes a director's prospects of serving on other companies' boards. Cassandra D. Marshall, in her empirical analysis of the job prospects of dissenting directors, found that "[o]n average, dissenting directors experience a net loss in board seats of 85% over the next five years."[216] Hence, directors have an inherent incentive to appease their colleagues. The modus operandi on many boards is one of cooperation.[217]

---

211 *Id.*

212 *Id.*

213 This is especially true given that while serving on the board, even dissenting directors do not necessarily have real impact on the decisions voted in the board. *See, e.g.*, Wei Jiang, Hualin Wan & Shan Zhao, *Reputation Concerns of Independent Directors: Evidence from Individual Director Voting*, 29 REV. FIN. STUD. 655 (2016) (examining the voting behavior of independent directors of public companies in China and finding that 92% of proposals they examined eventually passed despite dissention); *see also* Miriam Schwartz-Ziv & Michael S. Weisbach, *What do Boards Really Do? Evidence from Minutes of Board Meetings*, 108 J. FIN. ECON. 349 (2013) (analyzing board minutes of Israeli government-owned firms and reporting that even when directors voice concerns in meetings, they ultimately vote with management).

214 *See e.g.*, Luca Enriques, Henry Hansmann & Reinier Kraakman, *The Basic Governance Structure: The Interests of Shareholders as a Class*, *in* THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH 58 (2d ed., 2009) (noting that "ordinarily the board proposes the company's slate of nominees, which is rarely opposed at the annual shareholders meeting" (internal citation omitted)); BEBCHUK & FRIED, *supra* note 205, at 25 (concluding that "candidates placed on the company's slate by the board [are] virtually assured of being reelected").

215 BEBCHUK & FRIED, *supra* note 205, at 25 ("That directors have a desire to be reelected is clear.").

216 *See* Marshall, *supra* note 142.

217 Cox & Munsinger, *supra* note 210, at 91 (explaining that in selecting board members firms look for nominees whose "personality should be compatible with

Furthermore, the nature of the interaction among board members further incentivizes individual directors to cooperate.[218] Board members interact with each other on a continuous basis. An individual director who actively opposes a resolution that is spearheaded or backed by other directors may well find her future initiatives thwarted by her peers. As extensive game theoretic literature demonstrates, actors in repeated interactions tend to be cooperative if their counterparts are cooperative and non-cooperative when faced with non-cooperative behavior on the part of their peers.[219] Consequently, a director who ponders opposing her colleagues on the board must take into consideration not only the expected present cost associated with non-cooperation, but also the expected future cost and compare them to the expected benefit. Only if the expected benefit from dissention in the instant case outweighs the aggregate expected cost she should dissent. Thus, individual directors should dissent only in cases that are really important to them. Otherwise, it pays off to maintain solidarity with the other members of the board in the hope that they will reciprocate in the future.

The predisposition of individual directors to conform is amplified when a matter brought before the board falls squarely within another directors' field of expertise. Deference to expertise is a well-known phenomenon.[220] It marks all human interactions including interactions among directors.[221] Opposing an expert requires considerable investment of resources. A board member who wishes to oppose a director who is considered an expert will need to study the expert's field and then expend time and effort swaying the other members of the board, who are predisposed to accept the view of the expert. It must be born in mind, though, that directors hardly ever get a realistic chance to do their own research on topics of disagree-

---

that of the current directors" and who are likely to "cooperate with other board members in reaching decisions by group consensus").

218 *See* Bainbridge, *supra* note 34, at 32 (noting that board culture emphasizes "cooperation norms" leading to groupthink).

219 Robert Axelrod & William D. Hamilton, *The Evolution of Cooperation*, 211 SCI. 1390, 1390–91 (1981).

220 *See, e.g.*, Cass R. Sunstein, *Conformity and Dissent* 18 ((Univ. of Chi. Pub. Law & Legal Theory, Working Paper No. 34, 2002), https://chicagounbound.uchicago.edu/public_law_and_legal_theory/68 [https://perma.cc/U8PX-4NHF] (explaining that "[w]hen the morality of a situation is not clear, people might well be influenced by someone who seems to be an expert, able to weigh the risks involved").

221 *See* BEBCHUK & FRIED, *supra* note 205, at 32 (discussing how board members naturally defer to the CEO as a source of expertise).

ment. They often operate under severe time constraints that reinforce the tendency to abide by the judgment of experts.[222]

Similarly, when a board member relies on private information (as opposed to general or specific expertise) that bears on the matter before the board, it is nearly impossible to contest her view without access to the sources of the relevant private information. The need to act expeditiously, the lack of independent resources, and the norm of interpersonal trust make it very difficult for individual directors to contradict, or even challenge, peers who rely on private information sources.[223]

2. *Exit*

Ostensibly, exit is a straightforward solution for directors who do not see eye to eye with their peers. Upon closer inspection, however, it becomes apparent that resigning from a board is not a costless option. A director who resigns from a board is likely to pay a reputational price, especially if the decision over which she left is perceived as a standard decision by the outside world. Under such circumstances, the resigning director may be perceived as a "quitter," who cannot accept losing.[224] Such portrayal, in turn, can adversely affect her prospects of serving on other boards.[225]

Worse yet, two recent decisions of the Chancery court suggest the taking the "exit" route will not necessarily immunize a director from liability. The first, *In re Puda Coal Stockholders' Litigation*,[226] involved a claim of oversight failure against Puda

---

222 For discussion of the effect of time constraints on independent directors see BEBCHUK & FRIED, *supra* note 205, at 36–37 (noting that most independent directors have full-time careers of their own).

223 Melanie B. Leslie, *The Wisdom of Crowds? Groupthink and Nonprofit Governance*, 62 FLA. L. REV. 1179, 1183–84 (2010) (explaining that "[t]he chances that groupthink will occur increase in the absence of methodical decision-making procedures if the leader exhibits a 'closed' leadership style or if decision-makers lack sufficient information to enable them to arrive at an independent decision" (footnotes omitted)).

224 William O. Brown & Michael T. Maloney, *Exit, Voice, and the Role of Corporate Directors: Evidence from Acquisition Performance* 6 (Claremont Colls. Working Papers 1997–27, 1999), https://poseidon01.ssrn.com/delivery.php?ID=953069091068004126079120088111076085010081072032058071029065118124125090118012026009071101064017094023018004086085121121073094090070100086094077093106071011088025120086015102103114114073&EXT=pdf [https://perma.cc/MT4Q-8QR4] ("It is also possible that resignation from a board of directors may leave the director with an unwanted reputation as a quitter or as being weak.").

225 Bar-Hava, Gu & Lev, *supra* note 138, at 3 (observing that "a director's resignation likely affects negatively his/her reputation (rumored to be a troublemaker, not a team player)").

226 No. 6476-CS, 2013 Del. Ch. LEXIS 388 (Del. Ch. Feb. 6, 2013).

Coal's directors who failed to notice an extended series of unauthorized transfers of assets by the company's CEO and chairman of the board.[227] When the independent directors finally learned of the problem, they strove to conduct an investigation of the matter, but their attempt was thwarted.[228] In response, the individual directors decided to resign from the board.[229] In rejecting the independent directors' motion to dismiss the suit against them, Chancellor Leo E. Strine Jr. criticized the independent directors' decision to resign as it resulted in the abandonment of the company "under the sole dominion of a [CEO/chairman] they believe has pervasively breached his fiduciary duty of loyalty."[230] The correct course of action for the independent directors, per Chancellor Strine, was to influence the company to join the lawsuit.[231] Resigning was not only the wrong thing to do, but may have also constituted a breach of fiduciary duty.[232]

The second case, *Rich v. Chong*,[233] emerged when the auditors of Fuqi International, a Delaware company, uncovered that it made unauthorized cash transfers to third parties in the total amount of approximately $130 million.[234] A stockholders' suit from 2010 led to the opening of an investigation by the audit committee.[235] The investigation was subsequently abandoned, which led the independent directors of the companies to resign.[236] In this case, too, the chancery court refused to exonerate the resigning directors.[237] Vice Chancellor Glascock wrote "a conscious failure to act, in the face of a known duty, is a breach of the duty of loyalty."[238]

Exit is therefore far from being a panacea for individual directors. Directors wishing to exercise their exit options must be mindful of the consequences of their actions. Resigning over a mundane decision when a company is doing well may inflict a serious reputational cost on the existing director. Quitting over a serious matter when the company is facing hard times may even trigger legal liability.

---

227 *Id.* at *2–3.
228 *Id.* at *2.
229 *Id.* at *12–13
230 *Id.* at *13.
231 *Id.* at *20.
232 *Id.* at *19–20.
233 Rich *ex rel.* Fuqi Int'l. Inc. v. Chong, 66 A.3d 963, 984 (Del. Ch. 2013).
234 *Id.* at 966, 984.
235 *Id.* at 966.
236 *Id.*
237 *Id.* at 986.
238 *Id.* at 984.

IV
INCORPORATING A FIDUCIARY DUTY AMONG DIRECTORS AND OFFICERS

The duty of care and duty of loyalty are the two principal vehicles by which the law regulates the behavior of directors and corporate officers.[239] Yet, they only apply vertically toward the corporation and the shareholders. At present, they owe no fiduciary duty to one another.[240] In this part, we call for the introduction of a horizontal fiduciary duty among corporate officers and directors toward one another.

While, at first blush, this idea may appear radical, it is not. The concept of fiduciary duty is flexible and open-ended.[241] This is no accident. Fiduciary duties cover a broad range of relationships, each of which presents ever changing circumstances that require the fiduciary to make decisions in the best interest of the beneficiary.[242] Given the nature and scope of the cases covered by fiduciary duties, it is unsurprising that judges and legislators have elected to imbue the concept with a substantial degree of flexibility, making it an adaptable tool that can fit a wide array of cases.[243] As the Pennsylvania Supreme Court famously wrote in *In re Estate of Scott* "[t]he concept of a confidential relationship cannot be reduced to a catalogue of specific circumstances, invariably falling to the left or right of a definitional line."[244] Echoing the same sentiment, Deborah DeMott observed that "the fiduciary obligation is a device that enables the law to respond to a range of situations in which, for a variety of reasons, one person's discretion ought to be controlled because of characteristics of that person's relationship with another."[245]

---

239 *See* Eisenberg, *supra* note 197, at 945 (listing the duties of care and loyalty alongside the "duty to act lawfully").

240 *See supra* Part I, at 7–8.

241 Robert Cooter & Bradley J. Freedman, *The Fiduciary Relationship: Its Economic Character and Legal Consequences*, 66 N.Y.U. L. REV. 1045, 1046–47 (1991) (explaining that a "fiduciary should manage the [beneficiary's] asset in the beneficiary's best interests . . . however, the fiduciary's obligations are open-ended. Because asset management necessarily involves risk and uncertainty, the specific behavior of the fiduciary cannot be dictated [by specific rules] in advance").

242 *See id.* at 1045–46 (identifying familiar forms of fiduciary relationships such as director-officer and partner-partnership).

243 *See* Frankel, *supra* note 59, at 825–26 (describing how fiduciary duties can vary based on the fiduciary relationship, and how courts may even defer to the fiduciary where this deference would benefit the beneficiary).

244 *In re* Estate of Scott, 316 A.2d 883, 885 (Pa. 1974).

245 Deborah A. DeMott, *Beyond Metaphor: An Analysis of Fiduciary Obligation*, 1988 DUKE L.J 879, 915 (1988).

In general, fiduciary relationships arise when one party (the fiduciary) acts on behalf of another (the beneficiary) while exercising some discretion or power about how to perform her obligations in furtherance of the beneficiary's interests.[246] Fiduciary obligations pervade a variety of legal fields, contexts and situations "as a feature of interpersonal relationships."[247] Fiduciary relationships come in two varieties: formal and informal.[248] Formal fiduciary relationships are categorical in nature and are present in certain types of relationships, such as attorney-client, trustee-beneficiary, and corporate officers-shareholders.[249] Informal fiduciary relationships (often referred to as "confidential relationships") are circumstantial in their nature and derive from courts' qualitative evaluation of specific interpersonal interactions.[250]

The key to judicial findings of informal fiduciary relationships is the concept of trust.[251] As Professor Gordon Smith writes, "[a]lthough definitions of 'trust' vary, the term usually connotes some measure of vulnerability that emanates from the lack of legal or other protection against harm."[252] He proceeds to note that many commentators have argued that "trust

---

246 *See* Ernest J. Weinrib, *The Fiduciary Obligation*, 25 U. TORONTO L.J. 1, 4 (1975) (describing the elements of the fiduciary relationship); *see also* Paul B. Miller, *A Theory of Fiduciary Liability*, 56 MCGILL L.J. 235, 261 (2011) (positioning the discretionary power "wielded by fiduciaries over beneficiaries" as a central element of the fiduciary relationship).

247 Paul B. Miller, *Dimensions of Fiduciary Loyalty in* RESEARCH HANDBOOK ON FIDUCIARY LAW 182 (D. Gordon Smith & Andrew S. Gold eds., 2018), https://www.elgaronline.com/view/edcoll/9781784714826/9781784714826.xml [https://perma.cc/6X3F-XTGZ].

248 *See* D. Gordon Smith, *The Critical Resource Theory of Fiduciary Duty*, 55 VAND. L. REV. 1399, 1412 (2002) (explaining that "courts sensibly divide the universe of fiduciary relationships into two parts: 'formal' fiduciary relationships and 'informal' fiduciary relationships").

249 For those relationships see, *e.g.*, Frankel, *supra* note 59, at 795 (describing various forms of fiduciary relationships); Andrew S. Gold, *Interpreting Fiduciary Law*, *in* RESEARCH HANDBOOK ON FIDUCIARY LAW (D. Gordon Smith & Andrew S. Gold, eds., 2018) (analyzing how differing interpretive methodologies shape our understanding of fiduciary law); Smith, *supra* note 248, at 1412 (distinguishing between formal and informal fiduciary relationships).

250 For a discussion in the classification of formal and informal fiduciary relationship, see Smith, *supra* note 248, at 1412–13 (defining "formal" fiduciary relationships as easily recognizable cases like trustee-beneficiary or guardian-ward). Courts typically attempt to explain why fiduciary duties are imposed in informal fiduciary relationship (formal fiduciary relationships are considered fiduciary in nature). In doing so, they use common elements such as "(1) 'trust' or 'confidence' reposed by one person in another; and (2) the resulting 'domination,' 'superiority,' or 'undue influence' of the other." *Id.* at 1413–14 (footnotes omitted).

251 *See id.* at 1413–14 (listing trust as a necessary factor in judicial findings of informal fiduciary relationships).

252 *Id.* at 1418 (footnotes omitted).

is pervasive in commercial relationships" and in "relational contract[s]."[253]

Recent years have witnessed a spate of calls to recognize new fiduciary duties in a myriad of legal contexts. For example, Max Schanzenbach and Nadav Shoked have argued for the formalization of a fiduciary duty between officials and citizens in the municipal realm.[254] Similarly, Margaret Brinig has proposed that foster parents be viewed as fiduciaries of their children.[255] Finally, Ethan J. Lieb has called for the establishment of a fiduciary obligation among friends.[256]

We do not seek to push the boundaries of fiduciary law or extend it to new legal fields. Quite the contrary, our proposal comes within the ambit of the concept of fiduciary duty, as it was originally conceived. Our core innovation is to take the fiduciary model that exists in our corporate law and apply it horizontally. It bears emphasis that the concept of horizontal fiduciary duties is not new to the law.[257] It is not even new in the context of organizational law.[258] A fiduciary duty exists—indeed, has always existed—among the members of a partnership.[259] And partnerships belong in the same legal family as corporations.[260]

---

253 *Id.*

254 Max Schanzenbach & Nadav Shoked, *Reclaiming Fiduciary Law for the City*, 70 STAN. L. REV. 565, 575–78 (2018).

255 Margaret F. Brinig, *Parents: Trusted but not Trustees or (Foster) Parents as Fiduciaries*, 91 B.U. L. REV. 1231 (2011). The idea was inspired by the work of Elizabeth and Robert Scott, who, sixteen years earlier, applied fiduciary principles to biological parents. *See* Elizabeth S. Scott & Robert E. Scott, *Parents As Fiduciaries*, 81 VA. L. REV. 2401, 2402 (1995) ("Characterizing parents as fiduciaries suggests that the parent-child relationship shares important features with other legal relationships that have been similarly defined . . . . Basic structural similarities are apparent.").

256 Ethan J. Leib, *Friends As Fiduciaries*, 86 WASH. U. L. REV. 665, 686–700 (2009).

257 *See* Smith, *supra* note 248, at 1457 (noting the common-law origins of fiduciary duties in the partnership context).

258 *Id.*

259 *See* REVISED UNIF. P'SHIP ACT § 404(b) (1994); ALAN R. BROMBERG & LARRY E. RIBSTEIN, BROMBERG & RIBSTEIN ON PARTNERSHIP § 6.07(a) (Supp. 2004-2) (stating that "partners owe fiduciary duties to each other and to the partnership"); Smith, *supra* note 248, at 1458 ("The critical resource theory of fiduciary duty describes the structure of relationships in which courts apply fiduciary law. Partnerships fit easily within that structure, and courts predictably impose fiduciary duties in the partnership context."); Donald J. Weidner, *The Revised Uniform Partnership Act Midstream: Major Policy Decisions*, 21 U. TOL. L. REV. 825, 848 (1990) (stating that section 21(1) of the Uniform Partnership Act "has been treated by courts as the statutory foundation for powerful fiduciary duties among partners, particularly duties of loyalty").

260 Henry Hansmann, Reinier Kraakman & Richard Squire, *Law and the Rise of the Firm*, 119 HARV. L. REV. 1335, 1338 n.8 (2006) (concluding definitively that a

Corporate officers and especially directors can be readily analogized to partners who strive to achieve a common goal. To succeed in their quest, they must work together and trust each other. Corporate officers and directors typically have limited access to external expertise and are forced to rely on the collective knowledge and business acumen that exists within the corporation. As importantly, often, they cannot be effectively expected to challenge the integrity of their peers. In all relevant respects, therefore, corporate officers and directors are not different from partners. The time has come for the law to recognize this fact and impose fiduciary obligations on corporate officers and directors vis-à-vis one another.

Of course, this call of ours does not mark the end of the discussion. In an oft-cited paragraph, Justice Frankfurter wrote: "to say that a man is a fiduciary only begins analysis; it gives direction to further inquiry. To whom is he a fiduciary? What obligations does he owe as a fiduciary? In what respect has he failed to discharge these obligations? And what are the consequences of his deviation from duty?"[261] Heeding these sage words of advice, in the proceeding paragraphs we address these matters.

Under the legal regime we envision, directors and corporate officers would owe a fiduciary duty to one another. As is the case with horizontal fiduciary duties, the implementation of our model would result in a system of reciprocal obligations that would apply among the corporate officers and directors. A breach by one member of the group would therefore allow any of the other members to sue her. Each beneficiary would be at liberty to exercise (or not to exercise) her cause of action.

It is important to emphasize that the horizontal fiduciary duty we propose would complement, not replace, the fiduciary duty that corporate officers and directors already owe to the corporation. Violations of the horizontal fiduciary duty will therefore give rise to an independent cause of action that is distinct from that of the corporation. As we will explain, it is possible that an act or omission committed by a corporate officer or director would constitute a breach of both fiduciary duties. This would transpire, for example, if a corporate officer fails to disclose a conflict of interest or acts recklessly. In such cases, the fiduciary would be liable both to her peers and to the

partnership like a corporation is an independent legal "entity, albeit a weak one, and has been so under Anglo-American law since it acquired a rule of weak entity shielding more than 300 years ago").

261 *See* SEC v. Chenery Corp., 318 U.S. 80, 85–86 (1943).

corporation and would be exposed to two independent suits. A decision by the corporation to not bring a derivative suit would not stand as a bar to a possible suit by the corporation's officers and directors. Nor will the corporation's approval be a prerequisite for the filing of a suit for a breach of a horizontal fiduciary obligation.

In terms of the substance of the new fiduciary duty we propose, we believe that it should track as closely as possible the vertical fiduciary duty directors and officers owe the corporation. Keeping the two duties as similar as possible would minimize the burden and cost the new duty would impose on corporate officers and directors and facilitate compliance. Accordingly, the new duty we envision will be comprised of a duty of loyalty and duty of care. It would require officers and directors not to fail their peers in their common quest to pilot the corporation to success. As far as the loyalty aspect is concerned, it will be modelled on the more minimalist conception of conflict avoidance. Duty-bearers would be under an obligation to disclose to their peers all potential conflicts of interest that may compromise their commitment to the joint mission of serving the corporation. The existence of a potential conflict would not in itself bar a corporate office or a director from carrying out her duties. The same approval mechanisms that corporate law currently employs to address vertical conflicts of interest would also apply to horizontal ones. In this case, therefore, the recognition of a horizontal fiduciary duty would not impose additional costs on the corporation and its organs and will not impede decision making processes.

As for the duty of care, under our conceptualization the horizontal duty of care would closely mimic the traditional vertical duty that has long been in place. It would require duty bearers to act in a skillful and responsible manner and avoid negligent, reckless, or intentional behavior that might prevent their colleagues from preforming their task or compromise their ability to carry them out successfully. Breaches of the duty would consist of failure to inform oneself prior to making a decision, or voting on a matter brought before her, breaking the law or disregarding regulations that pertain to the corporation and its activities and failure to exercise independent judgment as required by the law.

As we already explained, lack of candor concerning potential conflicts and actions and omissions falling below the standard of behavior expected of skilled corporate officers and directors would give rise to potential liability under our proposal. It is critical to understand that while our proposal increases the exposure of corporate officers and directors to legal liability, it neither changes the nature of their fiduciary obligations, nor does it require them to discharge their duties differently. The principal effect of our proposal in this context is to enlarge the group of potential plaintiffs who can sue for a breach.

As for remedies, the standard remedy for breaches of the proposed horizontal fiduciary duty would be damages. Breaches of the horizontal duty of *care* would entitle the beneficiaries to monetary damages. Breaches of the duty of *loyalty* would be remedied either by damages or by disgorgement of profits. It should be noted in this context that even though the same act or omission may constitute a breach of both the vertical and horizontal fiduciary duties, the resulting harm may vary in each case. Breaches of the duty of loyalty may result in significant harm to the corporation if it lost a lucrative business opportunity, while inflicting only a modest harm on the corporate officers and directors.[262] Contrariwise, an erroneous decision on the part of the board of directors, resulting from a breach of the duty of care by a board member, may occasion a small economic loss on the corporation and a significant reputational harm on the other, non-negligent directors.[263]

The implementation of our proposal would yield four important benefits to corporate governance. First, it would improve information flows within the firm. By making directors and officers accountable to one another, the new duty would give them additional motivation to be scrupulous and diligent in performing their corporate roles. Second, the new cause of action we seek to introduce would allow directors and officers to clear themselves from guilt of fault, irrespective of the actions of the corporation. Importantly, this would enable individual officers and directors to protect their personal reputation when their peers lead the firm astray. Third, allowing individual directors and officers to prove in court that they did not breach their fiduciary duty to the firm should make it easier for corporations to attract honest directors and officers. Fourth, the introduction of a horizontal fiduciary duty would improve judicial oversight of firms. Corporate officers

262 *See* Guth v. Loft, 5 A.2d 503, 510 (Del. 1939) (noting that the duty of loyalty requires officers "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").

263 *See* Ibrahim, *supra* note 37, at 967 (noting that courts often leave breaches of the duty of care to "market, reputational, and social sanctions").

and directors know more about their firm than anyone else and can bring to light evidence that other plaintiffs may not be able to produce.

It should be emphasized that the aim of our proposal is not to increase litigation ex post, but rather, to provide better ex ante incentives to corporate officers and directors to act diligently and faithfully.

V
EXCULPATION, INSURANCE, AND INDEMNIFICATION

One may argue against our proposal, reasoning that its main effect would be to impose additional cost on corporations. The introduction of the new fiduciary duty we propose would prompt corporations to purchase for their officers and directors insurance policies that would guarantee them full reimbursement in the case of a judgment against them.[264] Similarly, corporations would promise to indemnify officers and directors for their litigation costs.[265] Some would even argue that corporations would rush to waive officers and directors liability by incorporating exculpating clauses into their contracts.[266] Hence, so the argument goes, the net effect of our proposal would be to burden corporations, without affecting the behavior of officers and directors. These arguments are greatly overstated and, in fact, largely miss the mark for the reasons we explain below.

A. Exculpation

Although exculpation clauses have become part of the lay of the corporate law land,[267] they will not have an effect in their

---

264 *See, e.g.*, Bernard Black, Brian Cheffins & Michael Klausner, *Outside Director Liability*, 58 STAN. L. REV. 1055, 1074–76 (2006) (reporting that the actual risk for outside directors of personally contributing to settlements out of their own pockets, is low due to directors and officers insurance policy).

265 JOSEPH WARREN BISHOP, JR., THE LAW OF CORPORATE OFFICERS AND DIRECTORS: INDEMNIFICATION AND INSURANCE § 6.01–02 (1981); *see also* Kurt A. Mayr II, *Indemnification of Directors and Officers: The Double Whammy of Mandatory Indemnification Under Delaware Law in* Waltuch v. Conticommodity Services, Inc., 42 VILL. L. REV. 223, 224 n.4 (1997) (summarizing indemnification clauses in corporate laws of leading states in the United States).

266 *In re* Cornerstone Therapeutics Inc. Stockholders Litig., 115 A.3d 1173 (Del. 2015) ("A plaintiff seeking only monetary damages must plead non-exculpated claims against a director who is protected by an exculpatory charter provision to survive a motion to dismiss, regardless of the underlying standard of review for the board's conduct—be it *Revlon Unocal*, the entire fairness standard, or the business judgment rule." (footnotes omitted)).

267 *See, e.g.*, DEL. CODE ANN. tit. 8, § 102(b)(7) (2007) (authorizing exculpation clauses for corporate directors).

familiar form on the horizontal fiduciary duty that we propose. A corporation can only waive a duty that it is owed.[268] It cannot waive a duty that is owed to its officers and directors. To argue otherwise evinces a complete misperception of the nature of the corporation as a separate legal entity, as well as of that of rights and duties. Only the officers and directors to whom the duty is owed can waive the right. Whether or not they would decide waive their right in the case of a breach is an empirical question. It should be noted in this context that, as we discussed in Part II, officers and directors are not a monolithic group. Individuals serving on those positions have divergent preferences and different attitudes toward risk. Therefore, it is reasonable to expect that certain officers and directors would waive the right, while others would not. And herein lies the key difference between our proposed horizontal right and the traditional vertical one. Unlike the vertical fiduciary duty that is owed to a single beneficiary—the firm—the horizontal fiduciary duty would create many beneficiaries. It is enough that some of them would decide not to waive it to keep it in effect. Only a full waiver by all of the right holders would keep the breach from being challenged.

Furthermore, it bears emphasis that even under extant law, exculpation clauses do not apply to corporate officers.[269] Corporate officers cannot be relieved of their fiduciary obligations.[270] In so far as directors are concerned, exculpation clauses only apply to breaches of the duty of care.[271] Violations of the duty of loyalty, or "acts or omissions [made] not in good faith or which involve intentional misconduct or a knowing violation of law" are nonexculpable.[272]

Similarly, we would make breaches of the duty loyalty nonexculpable. This would mean that even if corporate officers and directors wished to release their peers of the obligation to act loyally in the interactions amongst themselves and in ex-

---

268 *See, e.g.*, Gabriel Rauterberg & Eric Talley, *Contracting Out of the Fiduciary Duty of Loyalty: An Empirical Analysis of Corporate Opportunity Waivers*, 117 COLUM. L. REV. 1075 (2017) (discussing how companies and directors and managers can contract out specific fiduciary duties owned to the companies).

269 *See, e.g.*, DEL. CODE ANN. tit. 8 § 102(b)(7) (2007) (applying only to exculpation of corporate directors).

270 *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.").

271 DEL. CODE ANN. tit. 8, § 102(b)(7) (2007).

272 *Id.* For a detailed description of the Delaware exculpatory clause, see EDWARD P. WELCH ET AL., FOLK ON THE DELAWARE GENERAL CORPORATION LAW GCL-21–GCL-24 (2016) (discussing which types of claims are non-exculpable).

change be relieved of their obligation act in the same way, they will have no power to do so. Hence, the effect of exculpation clauses, even if they are adopted, would be limited to breaches of the duty of liability.

Finally, as Julian Velasco reminds us, even in the context of the duty of care, an exculpation provision "may eliminate personal liability for breach of the duty of care, [but] it does not eliminate the duty of care itself."[273] Thus, courts are not barred from awarding injunctive relief for breaches of the duty.[274] In our opinion, the same rule should apply to exculpation clauses that pertain to the horizontal duty of care. They should stand as no bar to injunctive relief.

For all these reasons, the effect of exculpatory provisions on our proposal should be quite modest. This, in turn, should lower the motivation of corporate officers and directors to insist on such provisions. As we explained, exculpatory provisions will immunize corporate officers and directors from litigation only if all their peers agree to them. Attempts to achieve this result through voluntary negotiations will likely be stifled by collective action problems and even if these problems can be overcome the impact of these provisions would be rather modest.

B. Insurance

Directors and officers insurance has become part and parcel of the corporate world.[275] Corporations routinely insure directors and officers against liability arising from breaches of their duty of care.[276] If our proposal is adopted, it is reasonable to expect that corporations would also purchase insurance against breaches of the horizontal fiduciary duty. One may therefore oppose our proposal on the grounds that it would

---

273 Julian Velasco, *How Many Fiduciary Duties Are There in Corporate Law?*, 83 S. CAL. L. REV 1231, 1256 (2010).

274 *Id.* (noting that "injunctive relief is not precluded").

275 Tom Baker & Sean J. Griffith, *Predicating Corporate Governance Risk: Evidence From the Directors' & Officers' Liability Insurance Market*, 74 U. CHI. L. REV. 487, 487 (2007) (arguing that "[n]early all public corporations purchase D&O policies" and referring to Tillinghast Towers Perrin, *2005 Directors and Officers Liability Survey* 20 fig.21 (2006) ("reporting that 100 percent of public company respondent in both the U.S. and Canada purchased D&O insurance")).

276 *See* Tom Baker & Sean J. Griffith, *The Missing Monitor in Corporate Governance: The Directors' & Officers' Liability Insurer*, 95 GEO. L.J. 1795, 1801 (2007) ("D&O insurance protects corporate officers and directors and the corporation itself from liabilities arising as a result of the conduct of directors and officers in their official capacity.").

have little effect on corporate officers and directors. This argument proves too much and too little at once.

It is noteworthy that this argument casts doubt on the desirability of other types of insurance.[277] It can be argued with equal force that automobile insurance removes drivers' incentive to drive carefully and that property insurance makes property owners apathetic about damages to their property. This conclusion is unwarranted.

First, the argument that the availability of insurance would make corporate officers and directors indifferent about the new fiduciary duty we propose is predicated on the assumption that *all* corporations would buy insurance for the relevant actors. There is no a priori reason to assume this. Corporations may or may not respond to our proposal by purchasing additional insurance for their officers and directors. It is equally possible that corporate officers and directors would prefer not to forego the option to be insured in exchange for higher pay.[278]

Second, insurance policies do not offer those insured prophylactic protection against liability. Insurance policies incorporate multiple exclusions and limitations.[279] Such exclusions and limitations are intended to combat the moral hazard problem that attends all insurance arrangements.[280] In our context, directors and officers insurance policies do not cover

---

[277] It is interesting to note that in the former Soviet Union there was a complete ban on liability coverage. *See* Steven Shavell, *On the Social Function and the Regulation of Liability Insurance*, 25 GENEVA PAPERS ON RISK AND INS. 166, 166 (2000) (noting that liability insurance might be considered "socially undesirable" since it potentially reduces policy holders' liability costs).

[278] In this regard, see, e.g., Canice Prendergast, *The Tenuous Trade-off Between Risk and Incentives*, 110 J. POL. ECON. 1071, 1071 (2002) (demonstrating how "the cost of offering a pay-for-performance contract to a (risk-averse) employee is that it imposes risk on his compensation, which causes higher wage costs").

[279] *See* Baker & Griffith, *supra* note 276, at 1804–05 ("The principal exclusions are for claims involving fraud or personal enrichment, claims either noticed or pending prior to the commencement of the policy period, and claims between insured persons." (footnotes omitted)).

[280] In the context of insurance, "moral hazard refers . . . to the tendency of insurance protection to alter an individual's motive to prevent loss." Steven Shavell, *On Moral Hazard and Insurance*, 93 Q.J. ECON. 541, 541 (1979). *See also* Richard Zeckhauser, *Medical Insurance: A Case Study of the Tradeoff between Risk Spreading and Appropriate Incentives*, 2 J. ECON. THEORY 10, 10 (1970) (arguing that health insurance incentivizes individuals towards "overexpenditure" but is necessary for effective risk-spreading); Tom Baker, *On the Genealogy of Moral Hazard*, 75 TEX. L. REV. 237, 239 (1996) ("'[M]oral hazard' refers to the tendency for insurance against loss to reduce incentives to prevent or minimize the cost of loss.").

harms resulting from intentional acts and omissions.[281] Moreover, since the line between negligence and gross negligence is not readily ascertainable,[282] those insured may rationally strive to refrain from acting negligently despite the existence of insurance.

Third, and finally, the cost of insurance does not remain steady.[283] The premium insureds have to pay depends on their past record.[284] A corporate officer or director who was found liable by a court and sought payment from her insurance company for the damages she was ordered to pay will see her premium go up precipitously.[285] This, in turn, will make her less employable relatively as the cost of hiring her would be higher relative to candidates with a clean record. Furthermore, insurance cannot expunge the reputational stain that attaches to a corporate officer or director who breached a fiduciary duty. Consequently, the availability of insurance should not lead corporate officers and directors to ignore their fiduciary duties vis-à-vis one another.

C. Indemnification

Indemnification provisions allow corporate officers and directors to receive reimbursement from their corporations for the expenditures they incur in civil and criminal proceedings.[286] They enable officers and directors to secure effective

---

281 Baker & Griffith, *supra* note 276, at 1820 ("[T]he D&O policy contains a moral hazard exclusion: the fraud exclusion against liability based on a 'dishonest, fraudulent, criminal act or omission or willful violation of any statute, rule or law.'").

282 *See* Velasco, *supra* note 273, at 1250 ("[T]he standard of conduct for the duty of care requires that each director act as an ordinarily careful and prudent person in similar circumstances, but the standard of review requires the shareholders to prove that the directors were grossly negligent . . . .").

283 *See* Baker & Griffith, *supra* note 276, at 1820–21 ("D&O insurance policies are re-priced once a year. . . . Re-pricing allows the insurer to take any increased hazard (moral or otherwise) into account.").

284 *Id.*

285 *See, e.g.*, Roberta Romano, *What Went Wrong With Directors' and Officers' Liability Insurance*, 14 DEL. J. CORP. L. 1, 6 (1989) ("In all likelihood, however, the most important impetus for the recent ratchet in D&O insurance premiums is the sheer increase in the number of claims filed against directors."); *see also* TOWERS WATSON DIRECTORS AND OFFICERS LIABILITY SURVEY: 2012 SUMMARY OF RESULTS 11 (2013) ("Nearly 30% of public companies indicated their premiums had increased, slightly more than double the 14% response in 2011."); *see also* Jane Croft, *Insurance: Directors Take Action Against Rising Tide of Litigation*, FIN. TIMES (Apr. 29, 2013), https://www.ft.com/content/b6920752-a678-11e2-bc0b-00144feabdc0 [https://perma.cc/UP7K-CBYE] (noting that "in certain sectors, such as financial services, premiums are rising because of the recent spate of scandals and insurers' increasing nervousness about offering cover").

286 DEL. CODE ANN. tit. 8, § 145(c) (2007).

legal representation when sued or investigated and let their corporations foot the bill.[287] Given the prevalence of indemnification provisions, it is reasonable to expect that indemnification would be offered, at least in some cases, to corporate officers and directors who get sued for violations of the horizontal fiduciary duty. This, in turn, would increase the financial burden placed on corporations. The magnitude of the increase would depend on three factors: first, the number of corporations that would offer officers and directors indemnification. Second, the cap that corporations set on indemnification amounts. Third, the number of suits filed.

As for the first factor, it should be noted that many of the acts and omissions that would trigger liability under our proposal involve bad faith. Hence, they would not give rise to indemnification claims.[288] The second factor, the amount at which indemnification would be capped, is an empirical matter. Naturally, we expect the amount to vary dramatically among firms, depending, inter alia, on their size. As for the third factor, we would like to emphasize once again that the point and purpose of our proposal to introduce a horizontal fiduciary duty into corporate law is not to increase operation costs for corporations, but rather to improve decision making within corporations and thereby enhance their profits and the returns of their shareholders. The introduction of a horizontal fiduciary duty is intended to deter wrongdoing and carelessness among corporate officers and directors. We expect the horizontal fiduciary duty to reinforce the vertical fiduciary duty. Making corporate officers and directors accountable to one another would induce them to act better in furthering the interests of the shareholders. Hence, if our proposal is implemented, it should be expected to increase the revenues of corporations, not their costs.

CONCLUSION

The rise of criminal and administrative enforcement campaigns against corporations has increased the level of inter-

---

[287] *See* Mayr II, *supra* note 265, at 230 (noting the "specter of the enormous attorney fees associated with defending against" claims against corporate directors and officers).

[288] *See* DEL. CODE ANN. tit. 8, § 145(a) (2007) ("A corporation shall have the power to indemnify any person . . . if the person acted in good faith and in a manner the person reasonably believed to be in or not opposed to the best interest of the corporation."); *see also* WELCH ET AL., *supra* note 272, at GCL-443 (discussing individuals' rights to indemnify themselves from a corporation).

dependence among corporate officers and directors.[289] A wrong committed by a corporate officer or director often results in a collective mark of Caine that attaches to all directors and officers of the corporation. Yet, since corporate officers and directors currently owe a fiduciary duty only to the firm, not to one another, corporate officers and directors have no independent cause of action against the wrongdoer. In this Article, we argued that the time has come to rectify this state of affairs by making corporate officers and directors fiduciaries not only of the firm but also of one another. Recognition of a horizontal fiduciary duty would not only allow individual directors and corporate officers to exonerate themselves from allegations of wrongdoing ex post, but would also improve corporate governance ex ante. The success of firms critically depends on the ability of their officers and directors to work together and trust each other. Our proposal is intended to enable corporate officers and directors to trust one another and thereby decrease the cost and improve the quality of corporate governance.

[289] *See* Koehler, *supra* note 70, at 531–38 (highlighting the disparity between corporate enforcement actions and related prosecutions of individual company employees).