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Dalia Tsuk Mitchell

George Washington University Law School, dtsuk@law.gwu.edu

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THE IMPORT OF HISTORY TO CORPORATE LAW

DALIA TSUK MITCHELL*

INTRODUCTION

Teaching directors' duties has become increasingly perplexing. In a series of decisions beginning in the 1990s, the Delaware courts, attempting to infuse new meanings into traditional concepts—namely, good faith, due care, and loyalty—have left the terrain of directors' duties in disarray.¹ To make sense of rulings that appear inconsistent, one can take solace in Justice Holmes's often-repeated aphorism: "The life of law has not been logic; it has been experience."² In corporate law, experience shows that the courts' changing views of directors' duties reflect a broader shift—from a corporate law grounded in business practice to one anchored in, and ultimately trumped by, modern finance theory.

In my Corporations class, I start the discussion of directors' duties with the duty of loyalty—the authentic fiduciary obligation. We cover cases addressing self-dealing transactions, corporate opportunity, and executive compensation. We then proceed to the tort-based duty of care. We start with *Francis v. United Jersey Bank*³ or *Graham v. Allis-Chalmers Manufacturing Co.*,⁴ which I discuss in this Article, to explore the tort and business origins of the duty of care. My class then turns to the business judgment rule, reading *Kamin v. American Express Company*⁵ and *Joy v. North*⁶ to explore justifications for the rule, and *Cede & Co. v. Technicolor, Inc.*⁷ to examine the relationship between

* Professor of Law, The George Washington University Law School.

1. See, e.g., Stephen M. Bainbridge et al., *The Convergence of Good Faith and Oversight*, 55 UCLA L. REV. 559, 561–62 (2008).

2. OLIVER WENDELL HOLMES, JR., THE COMMON LAW 1 (1881) ("The life of the law has not been logic; it has been experience. The felt necessities of the time, the prevalent moral and political theories, intuitions of public policy, avowed or unconscious, even the prejudices which judges share with their fellow-men, have had a good deal more to do than the syllogism in determining the rules by which men should be governed. The law embodies the story of a nation's development through many centuries, and it cannot be dealt with as if it contained only the axioms and corollaries of a book of mathematics.")

3. 432 A.2d 814 (N.J. 1981).

4. 188 A.2d 125 (Del. 1963).

5. 86 Misc. 2d 809 (1976).

6. 692 F.2d 880 (2d Cir. 1982).

7. 634 A.2d 345 (Del. 1993).

the rule and the duty of care. The remainder of our discussion of directors' duties is devoted to what I label the "dormant duty of care"—that is, what was left of the duty of care after the enactment of section 102(b)(7) of the Delaware General Corporation Law.⁸ We examine the dormant duty of care in *In re Caremark International Inc. Derivative Litigation*,⁹ *In re Walt Disney Derivative Litigation*,¹⁰ *Stone v. Ritter*,¹¹ and *In re Citigroup Inc. Shareholder Derivative Litigation*.¹² Reading these cases in chronological order allows us to explore recent changes in Delaware law as well as the disorder they left behind.

The evolution of the directors' duty to monitor—from *Graham* to *Caremark* to *Stone* and *Citigroup*—is germane to our discussion of directors' duties and Delaware's law more broadly. In the second half of the twentieth century, the standard applicable to claims involving breach of the duty to monitor has shifted from negligence (in *Graham*) to business judgment to good faith (in *Caremark*), and the duty itself was altered from a subset of the duty of care (in *Graham* and *Caremark*) to a subcategory of the duty of loyalty (in *Stone* and *Citigroup*). The latter change is particularly perplexing but, as I suggest to my students, the broader historical shift from business to finance in which these decisions are situated might alleviate at least some of the confusion. As my class explores the influence of business practice in the mid-century years,¹³ law's emphasis on structure and process in the 1970s and 1980s,¹⁴ and ultimately the triumph of finance over law in the 1990s,¹⁵ we examine how the rhetoric of care, business judgment, and good faith helped assure investors that they could trust their corporate managers while simultaneously rendering the duty to monitor (and the duty of care more broadly) inconsequential. Law's role was reduced to enabling the development of powerful corporations, outside the law.

This Article examines how I teach the development of the duty to monitor, but the themes I explore, divided into specific lessons (or parts in this Article), are not limited to the cases I discuss below. Drawing on business and legal theory, specifically different ideas about the role of the board of directors and finance, these lessons can be used to explain other changes in corporate law

8. DEL. CODE ANN. tit. 8, § 102(b)(7) (2014); see LAWRENCE E. MITCHELL & DALIA T. MITCHELL, CORPORATIONS: CASES AND MATERIALS 277–360 (2d ed. 2011) (identifying and examining the dormant duty of care).

9. 698 A.2d 959 (Del. Ch. 1996).

10. 906 A.2d 27 (Del. 2006).

11. 911 A.2d 362 (Del. 2006).

12. 964 A.2d 106 (Del. Ch. 2009).

13. See *infra* Part I.

14. See *infra* Part II.

15. See *infra* Part IV.

beginning in the second half of the twentieth century and culminating at the turn of the twenty-first century.

I. GRAHAM AND MID-CENTURY MANAGERIALISM—THE INFLUENCE OF BUSINESS PRACTICE ON LEGAL DOCTRINE

The modern discourse of directors' duties begins with mid-century managerialism, an ideology that business theorists embraced amidst the growing decentralization of corporations and the development of complex managerial structures.¹⁶ Focusing on management's expertise, business theorists and social scientists put corporate management at the center of the corporation, empowering management to control business affairs, to exercise authority over others in the corporate structure, and to use corporate power over those outside the firm.¹⁷

By midcentury, the term "free enterprise"—in use since the 1930s—came to symbolize the free reign of managers, who in the cultural imagination replaced the small producers and entrepreneurs of the nineteenth century.¹⁸ In the post-war years, as "Marxist-inspired theoretical conceptualizations [were rendered] ideologically suspect,"¹⁹ not ownership of property or social status, but an ability to run an enterprise legitimized managers' powers.²⁰ The new managerial class was a loose class of leaders, presumably free from the constraints of the old world.²¹ For the most part, senior management faithfully carried on the responsibilities associated with their position.²²

Influenced by managerialist theories articulated by business scholars, mid-century corporate law scholars, who lumped together directors and officers under the rubric of management, viewed managers as experts who, while "not amenable to direct shareholder control, nevertheless serve shareholder interests."²³ The "shareholder interest" was not determined by reference to

16. See, e.g., PETER F. DRUCKER, *THE CONCEPT OF THE CORPORATION* 41–71 (1972) (first published in 1946, examining General Motors' complex managerial structure).

17. William W. Bratton, Jr., *The "Nexus of Contracts" Corporation: A Critical Appraisal*, 74 CORNELL L. REV. 407, 413 (1989).

18. Cf. Nelson Lichtenstein, *Taft-Hartley: A Slave-Labor Law?*, 47 CATH. U. L. REV. 763, 771 (1998) (explaining the use of the term "free enterprise" to describe the American capitalist system).

19. Rick Fantasia, *From Class Consciousness to Culture, Action, and Social Organization*, 21 ANN. REV. SOC. 269 (1995).

20. Daniel Bell, *The Power Elite—Reconsidered*, 64 AM. J. SOC. 238, 247 (1958).

21. Davita Silfen Glasberg & Michael Schwartz, *Ownership and Control of Corporations*, 9 ANN. REV. SOC. 311, 313 (1983).

22. Brian R. Cheffins, *The Corporate Governance Movement, Banks and the Financial Crisis* (Univ. of Cambridge Faculty of Law Research Paper Series, Paper No. 56/2013), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2365738.

23. Gerald E. Frug, *The Ideology of Bureaucracy in American Law*, 97 HARV. L. REV. 1277, 1307 (1984).

shareholders' subjective, and potentially conflicting, desires. Rather, it was an "objectified abstraction" determined by "the bureaucratic managers" and "attributed to all shareholders of all corporations whether they want it or not."²⁴ Management had full discretion to determine the "shareholder interest," while "shareholder interest" presumably constrained management's power.²⁵ Reflecting this circularity of power and restraint, courts developed the presumption of the business judgment rule to allow corporate managers to run their businesses with little if any intervention from the shareholders.²⁶

The leading jurisdiction in the 1940s and 1950s was New York, where the courts, in an attempt to give more discretion to management, gradually allowed exemptions to directors' liability to encroach upon the standard of care applicable to their actions.²⁷ Earlier cases viewed the business judgment rule as "an adjunct to finding that diligence in the decision-making process had in fact been exercised."²⁸ If reasonable care was exercised in the decision-making process, a court would not examine "the merits of the decision" as that would involve assessing business judgment.²⁹ In later cases, despite attempts to keep the duty of care alive, the business judgment rule gained a force of its own. It became a means of shielding directors from liability, of changing the standard of liability applicable to their actions. Not only honest mistakes but all actions, unless they were fraudulent or tainted with a conflict of interest, were exempt from liability.³⁰

Delaware's history was different. By the time *Graham* came before the Supreme Court of Delaware, the court, fully embracing managerialism's emphasis on directors' discretion, had not yet developed the precepts of its duty of care jurisprudence but had a "'business judgment' jurisprudence" independent of that duty.³¹ *Graham*, a case involving directorial lack of monitoring, required the court to begin developing its duty of care jurisprudence as no business decision was made.³² As Lyman Johnson writes, *Graham* was the first Delaware case to "explicitly acknowledge" the duty of care.³³

24. *Id.* at 1308.

25. *Id.* at 1306–07.

26. *Id.*

27. Dalia Tsuk Mitchell, *Status Bound: The Twentieth Century Evolution of Directors' Liability*, 5 N.Y.U. J. L. & BUS. 63, 113–23 (2009).

28. Stuart R. Cohn, *Demise of the Director's Duty of Care: Judicial Avoidance of Standards and Sanctions Through the Business Judgment Rule*, 62 TEX. L. REV. 591, 603 (1983).

29. *Id.*

30. Mitchell, *supra* note 27, at 119–20.

31. Lyman Johnson, *The Modest Business Judgment Rule*, 55 BUS. LAW. 625, 639 (2000).

32. *Id.* at 639.

33. *Id.* See also Henry Ridgely Horsey, *The Duty of Care Component of the Delaware Business Judgment Rule*, 19 DEL. J. CORP. L. 971, 982–83 (1994) ("No Delaware court decision

Graham was a derivative suit against the directors of Allis-Chalmers Manufacturing Company for damages caused to the corporation by the non-director employees' and the corporation's violations of antitrust regulations on a price-fixing conspiracy in the electrical equipment industry. The shareholder plaintiffs charged that the directors were liable for breach of their duties "by reason of their failure to take action designed to learn and prevent anti-trust activity on the part of any employees of Allis-Chalmers."³⁴

The court, unable to defer to the board's business judgment, treated *Graham* as a typical tort case using a negligence standard to evaluate directors' inaction.³⁵ Yet, a heightened standard did not result in stricter duties. Embracing the ideology of managerialism, the court stressed that Allis-Chalmers Manufacturing Company was a highly decentralized corporation with authority delegated to the "lowest possible management level capable of fulfilling the delegated responsibility."³⁶ Given "the extent and complexity of the company's operations," the board's role was limited to considering and deciding "matters concerning the general business policy of the company."³⁷ Justice Wolcott did not see fault in such practice concluding that, due to the company's structure, the board could not "consider in detail specific problems of the various divisions."³⁸

The duties of Allis-Chalmers' directors were "fixed by the nature of the enterprise which employed in excess of 30,000 persons and extended over a large geographical area."³⁹ Justice Wolcott accepted that "[b]y force of necessity," the directors could not know all the company's employees or be aware of their actions.⁴⁰ "The very magnitude of the enterprise required them to confine their control to the broad policy decisions" and entitled them (by virtue also of section 141(f) of Delaware General Corporations Law) to rely on "summaries, reports, and corporate records."⁴¹ Imposing a limited duty to respond rather than an affirmative duty to monitor, Justice Wolcott reasoned: "[D]irectors are entitled to rely on the honesty and integrity of their

espouses the existence of a director's fiduciary duty to act in an informed manner and with the care of a prudent man until the decision of our separately constituted supreme court in 1963 in *Graham v. Allis-Chalmers Manufacturing Co.*").

34. *Graham v. Allis-Chalmers Mfg. Co.*, 188 A.2d 125, 127 (Del. 1963). These employees and the corporation entered guilty pleas to the antitrust indictments. *Id.*

35. *Id.* at 130.

36. *Id.* at 128.

37. *Id.*

38. *Id.*

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

40. *Id.*

41. *Id.*

subordinates until something occurs to put them on suspicion that something is wrong.⁴²

The history of finance helps explain how corporations and corporate law could so easily refuse to hold directors liable without any concern about potential repercussions from investors. Managerialism and its associated deference to directors' expert judgment went hand in hand with reliance on internal finance, which shielded the control group from the discipline of the stock market and public shareholders. Corporations obtained external financing largely from banks with whom corporate management had close relationships and whose representatives often sat on corporate boards. Corporate management was running corporations for the sake of business, without undertaking unnecessary risks, and politicians did not wish to disturb American business during one of its greatest periods of expansion.⁴³

The business judgment rule, as it developed during the mid-century years, and the court's decision in *Graham* reflected the dominant business practice and the managerialist theory that legitimated it. The following part (or lesson) explores developments taking place a couple of decades later when the legal community's vision of the directors' role and its financial underpinning was transformed, leading the courts to embrace the monitoring model of the board and to alter corporate law's focus from business practice to finance. As my class explores, *Caremark* brought these changes to bear upon the duty to monitor.

II. THE 1970S AND 1980S REVOLUTION—FROM BUSINESS PRACTICE TO LEGAL STRUCTURES

Beginning in the 1970s, the corporate board came to the forefront of academic and political debates—the focus of policymakers' attention.⁴⁴ Social and political upheavals led public-interest shareholder groups to use the SEC's proxy and shareholder proposal rules to voice their opposition to corporate practices related to the Vietnam War, environmental protection, occupational safety, and equal employment. Institutional investors became major players in corporate governance, raising new questions about the control of corporate America. Several corporate bankruptcies, including the sudden and unexpected collapse of Penn Central, raised grave doubts about their boards' performance,

42. *Id.*

43. Lawrence E. Mitchell & Dalia T. Mitchell, *The Financial Determinants of American Corporate Governance: A Brief History*, in CORPORATE GOVERNANCE: A SYNTHESIS OF THEORY, RESEARCH, AND PRACTICE 19, 27–28 (H. Kent Baker and Ronald Anderson, eds., 2010).

44. As an example of this growing attention, see *Officers' and Directors' Responsibilities and Liabilities*, BUS. LAW., Feb. 1972, at 1, 1–178.

while corporate scandals involving illegal political contributions revealed during the Watergate investigation exacerbated such doubts.⁴⁵

A variety of studies concluded that the boards of directors of large and medium-sized corporations were no longer a significant check on the CEO; they did not even have much say in selecting the executives because the proxy machinery was controlled by management. Outside directors were ineffective. They were typically chosen from the same social networks as the top executives and sitting with the latter on several boards; they were thus unlikely to challenge the executives. Finally, studies revealed that most boards did not meet frequently enough to perform a meaningful role.⁴⁶

Several proposals for reform followed,⁴⁷ ultimately converging on the monitoring model of the board. It described directors as “overseers of the corporation and monitors of corporate management” and recommended that a significant number of outside directors serve on the board.⁴⁸ But consensus was limited to the fact that independent directors should play an important role in reviewing the activities of the executives. What that meant as far as the duties and liabilities of directors, and to whom directors owed those duties, remained contested issues throughout the 1980s.⁴⁹

While some legal scholars wanted to use the monitoring model substantially to redefine directors’ duties,⁵⁰ corporate lawyers and business groups were strongly opposed to any attempt to tinker with the very limited directorial duties. They focused on the monitoring role of non-management directors and suggested that good boards should have a specific number of

45. Joel Seligman, *A Sheep in Wolf's Clothing: The American Law Institute Principles of Corporate Governance Project*, 55 GEO. WASH. L. REV. 325, 328–35 (1987).

46. *Id.* at 330–32. See also Horsey, *supra* note 33, at 991; Lawrence E. Mitchell, *The Trouble with Boards*, in PERSPECTIVES ON CORPORATE GOVERNANCE 17, 29–30 (F. Scott Keiff & Troy A. Paredes eds., 2010) (noting, among others, the 1971 study by Myles Mace regarding corporate boards’ passivity).

47. See, e.g., William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663, 701–03 (1974) (proposing the enactment of federal “minimum standards” for officers and directors of firms of a certain size); RALPH NADER ET AL., TAMING THE GIANT CORPORATION 66, 76–77, 120, 126–27 (1976) (reintroducing the idea that firms of a certain income and employee-base should be federally incorporated; the federal statute was to include specific requirements regarding board composition and the board’s role); Harvey J. Goldschmid, *The Greening of the Board Room: Reflections on Corporate Responsibility*, 10 COLUM. J.L. & SOC. PROBS. 15, 25–26 (1973) (suggesting requiring boards to be composed entirely of outside directors who would review the executives’ decisions).

48. See, e.g., *Corporate Director's Guidebook*, 32 BUS. LAW. 5, 31, 33 (1976) and its revised edition, *Corporate Director's Guidebook*, 33 BUS. LAW. 1591, 1619, 1622–27 (1978) [hereinafter *Corporate Director's Guidebook II*]. See also Seligman, *supra* note 45, at 341.

49. Mitchell, *supra* note 46, at 52.

50. See, e.g., Melvin Aron Eisenberg, *Legal Models of Management Structure in the Modern Corporation: Officers, Directors, and Accountants*, 63 CALIF. L. REV. 375, 403–18 (1975).

them.⁵¹ Moreover, as the business community saw it, the monitoring board had one task—the directors' role was "to monitor, in an environment of loyal but independent oversight, the conduct of the business and affairs of the corporation in behalf of those who invest in the corporation."⁵² Directors were not to be representatives of different corporate constituencies. According to the business community and its lawyers, directors' monitoring powers were meant to achieve share price maximization.⁵³

During the 1980s, the Delaware courts brought the legal community's emphasis on independent oversight "to bear upon their analysis of directors' duties and the business judgment rule."⁵⁴ Fully embracing the model as a structural rather than substantive one, the Delaware courts focused on the role of the independent directors (independence narrowly defined as lack of control or domination by an individual interested in the transaction).⁵⁵ If a majority of independent disinterested directors, following the courts' procedural requirements, approved the board's actions, the courts declared such actions to be shielded from further judicial inquiry.⁵⁶

Delaware's embrace of the monitoring model as a means of shielding directors from liability reached further. In *Aronson v. Lewis*, the Supreme Court of Delaware declared that the business judgment rule—"an acknowledgment of the managerial prerogatives of Delaware directors"—was

51. See, e.g., *Corporate Director's Guidebook II*, *supra* note 48, at 1619, 1622.

52. *Id.* at 1621.

53. Mitchell, *supra* note 46, at 44–45. On the relationship between the monitoring board and share price maximization, see Frank H. Easterbrook, *Managers' Discretion and Investors' Welfare: Theories and Evidence*, 9 DEL. J. CORP. L. 540, 554–56 (1984); Ira M. Millstein & Paul W. MacAvoy, *The Active Board of Directors and Performance of the Large Publicly Traded Corporation*, 98 COLUM. L. REV. 1283, 1292 (1998); 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, 1526–35 (2007).

54. Mitchell, *supra* note 27, at 138.

55. *Grobow v. Perot*, 539 A.2d 180, 188–89 (Del. 1988). See also, Usha Rodrigues, *The Fetishization of Independence*, 33 J. CORP. L. 447, 465 (2008) (examining the Delaware courts' inquiry into independence); Alan R. Palmiter, *Reshaping the Corporate Fiduciary Model: A Director's Duty of Independence*, 67 TEX. L. REV. 1351, 1351 (1989) (advocating a director's separate duty of independence).

56. *Moran v. Household Int'l, Inc.*, 500 A.2d 1346, 1356 (Del. 1985) (noting that when directors adopt a defensive tactic, their ability to fulfill their *Unocal* duties is "materially enhanced . . . where . . . a majority of the board favoring the proposal consisted of outside independent directors who have acted in accordance with the foregoing standards."); *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 176 n.3 (Del. 1986) ("[C]ertain presumptions . . . generally attach to the decisions of a board whose majority consists of truly outside independent directors."); *Paramount Commc'ns, Inc. v. Time Inc.*, 571 A.2d 1140, 1154 (Del. 1989) (noting that the evidence supporting the conclusion that in making its decision the Time's board was not uninformed "is materially enhanced by the fact that twelve of Time's sixteen board members were outside independent directors.").

a presumption “that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.”⁵⁷ Placing the burden of rebutting the presumption on the party challenging the decision, the court held that “[a]bsent an abuse of discretion, [directors’] judgment will be respected by the courts.”⁵⁸ The court further announced that “[w]hile the Delaware cases use a variety of terms to describe the applicable standard of care, our analysis satisfies us that under the business judgment rule director liability is predicated upon concepts of gross negligence.”⁵⁹

The “informed” element was not part of the business judgment rule doctrine until *Aronson* introduced it. In adding it, *Aronson* laid the foundation for the ultimate equation of the substantive duty of care with the procedural (or structural) duty to be informed.⁶⁰ Precedent also did not support the court’s conclusion that gross negligence was the standard of care applicable to directors.⁶¹ But a year later, in *Smith v. Van Gorkom*, the case that shocked the business and legal communities by finding directors liable for breach of the duty of care, the Supreme Court of Delaware confirmed its own proclamation in *Aronson* that “under the business judgment rule director liability is predicated upon concepts of gross negligence.”⁶² Moreover, the court in *Van Gorkom* concluded that “the concept of gross negligence is also the proper

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

58. *Id.*

59. *Id.*

60. Johnson, *supra* note 31, at 641. According to Johnson, *Aronson* changed the traditional presumption that directors acted “in good faith” in the exercise of their best judgment “for what they believed to be the interest of the corporation” and all its stockholders into a presumption that “in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.” *Id.* at 639–40. For the traditional formulation of the rule, see, e.g., *Bodell v. Gen. Gas & Elec. Corp.*, 140 A. 264, 267 (Del. 1927).

61. Samuel Arsht’s review of Delaware cases a few years before *Aronson* was decided revealed that most of the cases cited in *Aronson* dealt with “parent-subsidiary transactions where a determination of fairness is meaningless or impossible” In these situations, the courts had “characterize[ed] the ‘gross and palpable overreaching’ standard as a ‘business judgment’ test.” But, as Arsht demonstrated, this was not a generally applicable test. Other cases cited in *Aronson* simply stated that the court would not interfere with the board’s judgment absent evidence of fraud or gross abuse of discretion. One case suggested that directors might be liable for gross negligence, but did not negate the possibility of liability for negligence. S. Samuel Arsht, *The Business Judgment Rule Revisited*, 8 HOFSTRA L. REV. 93, 102, 112–13 (1980). Even the Delaware Supreme Court admitted that “the Delaware cases have not been precise in articulating the standard by which the exercise of business judgment is governed.” *Aronson*, 473 A.2d at 812 n.6. Nonetheless it chose to characterize the cases as “hold[ing] that director liability is predicated on a standard which is less exacting than simple negligence.” *Id.*

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

standard for determining whether a business judgment reached by a board of directors was an informed one.”⁶³

The mid-century rule of deference to expert opinion had become in the 1980s a structural procedural defense precluding judicial inquiry into the directors’ challenged actions. Unless a plaintiff arguing a breach of the duty of care could demonstrate that the directors were grossly negligent (that is, grossly negligent with respect to the requirement to be informed), the directors would have the presumption of the business judgment rule and the court would not second-guess their actions. The following parts (or lessons) explore how, by the time *Caremark* was decided, the presumption of the business judgment rule helped dissociate the high rhetoric surrounding the duty to monitor from potential liability.

III. AFTER THE REVOLUTION—THE DUTY TO MONITOR IN *CAREMARK*

Caremark involved the settlement of a shareholders derivative suit to recover damages from Caremark’s directors for fines the corporation incurred in settling federal and state lawsuits addressing kickback payments that violated the terms of the Anti-Referral Payments Law. Invoking *Graham*, the plaintiff shareholder argued that the losses were a result of the board’s failure to monitor Caremark’s officers and employees.⁶⁴

Caremark International—a health care corporation—was a highly decentralized corporation with “approximately 7,000 employees and ninety branch operations.”⁶⁵ Its size was not remarkable, though. Beginning in the 1970s, U.S. publicly held corporations were growing larger. They were also “operating in a more volatile market environment due to deregulation, increased competition and technological advances reducing barriers to entry in many industries.”⁶⁶ While such developments might have triggered closer scrutiny of the executives, the Delaware courts, as the following elaborates, saw matters differently. Shielding the board from liability, the courts empowered the executives to act without fearing intervention (or even monitoring) from their monitors.

Chancellor Allen began his decision by emphasizing that, at the twentieth-century’s end (more than three decades after *Graham* was decided), boards could not “satisfy their obligation to be reasonably informed concerning the corporation, without assuring themselves that information and reporting systems exist in the organization that are reasonably designed to provide to senior management and to the board itself timely, accurate information” so that

63. *Id.* Interestingly, what “gross negligence” meant remained an open question. *Rabkin v. Philip A. Hunt Chem. Corp.*, 547 A.2d 963, 970 (Del. Ch. 1986).

64. *In re Caremark Int’l Derivative Litigation*, 698 A.2d 959, 967 (Del. Ch. 1996).

65. *Id.* at 962.

66. Cheffins, *supra* note 22, at 11.

the latter could “reach informed judgments concerning both the corporation’s compliance with law and its business performance.”⁶⁷ Directors had an affirmative duty to ensure systematic monitoring.⁶⁸

High ideals of business practices did not support heightened duties. Just as Allen required directors to install reporting systems, he ensured that proving directors’ failure to act would be nearly impossible. *Graham* used a negligence standard to evaluate directors’ failure to monitor. But if, as Allen held, directors had an affirmative duty to design information and reporting systems, their decisions as to the appropriate reporting systems would be subject to the presumption of the business judgment rule and evaluated using a standard of gross negligence.⁶⁹ Furthermore, because section 102(b)(7) of the Delaware General Corporation Law, which was enacted in 1986, allowed corporations to exculpate directors for monetary liability for breaches of the duty of care, but not for acting in bad faith, Allen substituted good faith for gross negligence. So long as the board exercised “a good faith judgment” as to the adequacy of the corporation’s information and reporting system, it could not be held liable for the system’s failure to reveal violations of law or duties by officers or employees.⁷⁰

Relying on good faith to replace both the duty of care and the business judgment rule, Allen stressed that the standard of good faith did not require an assessment of the substance of the board’s decision. “[C]ompliance with a director’s duty of care[,]” Allen wrote, “can never appropriately be judicially determined by reference to *the content of the board decision* that leads to a corporate loss, apart from consideration of the good faith *or* rationality of the process employed.”⁷¹ After-the-fact determinations that the decision was “substantively wrong,” “stupid,” “egregious,” or “irrational” did not entail liability.⁷² Rather, the standard of good faith required a determination by the court that the process in which a compliance system was adopted “was either rational or employed in a *good faith* effort to advance corporate interests.”⁷³ “[O]nly 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 exi[s]ts—will establish the lack of good faith that is a necessary condition to liability.”⁷⁴

67. *In re Caremark*, 698 A.2d at 970.

68. *Id.*

69. *Id.* at 969–71.

70. *Id.* at 970–71.

71. *Id.* at 967.

72. *In re Caremark*, 698 A.2d at 967.

73. *Id.*

74. *Id.* at 971. For examinations of good faith, see Sarah Helene Duggin & Stephen M. Goldman, *Restoring Trust in Corporate Directors: The Disney Standard and the ‘New’ Good Faith*, 56 AM. U. L. REV. 211, 232–37 (2006); Hillary A. Sale, *Monitoring Caremark’s Good*

The tort based duty of care, subsumed first under the business judgment rule and now under good faith, was no longer relevant. In a footnote, Allen put it to sleep. “The vocabulary of negligence while often employed,” he noted, “is not well-suited to judicial review of board attentiveness,” especially, albeit not only, if such usage implies looking at “the substance of the decision as any evidence of possible ‘negligence.’”⁷⁵ A substantive standard of care no longer attached to the directors’ duty of care or their duty to monitor. As long as directors, insiders and outsiders alike, did not consciously disregard their duties, the Delaware courts would not reevaluate their decisions or lack thereof. The monitoring board’s duty to monitor became merely rhetorical.

How could rhetoric so easily be separated from duties, ideals from practice, without triggering investors’ irk? The following part (or lesson) explores how Delaware’s analysis in the last decades of the twentieth century, as exhibited in *Caremark*, limited the shareholders’ interests to the maximization of profit. Shareholders were instructed to find security neither in business practice nor in the structure of the board and its decision-making processes, but in finance.

IV. FROM BUSINESS PRACTICE, THROUGH STRUCTURE, TO FINANCE

A rule of deference to the directors’ expert judgment, as articulated in *Graham*, seemed to fit a time when corporations (and directors) relied on internal finance. The monitoring model of the board was established on a very different financial background—one in which public stock ownership, especially institutional ownership, was steadily increasing. By 1965, more than ten percent of the population owned stock. In 2002, more than twenty-nine percent of the total population directly owned stock. In 1950, institutional investors held approximately eight percent of equities. Four decades later, institutions held more than forty-five percent of total equities in the United States.⁷⁶

Faith, 32 DEL. J. CORP. L. 719 (2007). For an innovative analysis of the benefits of the business judgment’s rule emphasis on process, see Lynn A. Stout, *In Praise of Procedure: An Economic and Behavioral Defense of Smith v. Van Gorkom and the Business Judgment Rule*, 96 NW. U. L. REV. 675 (2002).

75. *In re Caremark*, 698 A.2d at 967 n.16.

76. Mitchell & Mitchell, *supra* note 43, at 30. For detailed discussions of these developments, see Lawrence E. Mitchell, *Who Needs the Stock Market? Part I: The Empirical Evidence*, 1 ACCT., ECONS., & LAW: A CONVIVIVUM (2010); Ronald J. Gilson & Jeffrey N. Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights*, 113 COLUM. L. REV. 863 (2013); Ronald J. Gilson & Jeffrey N. Gordon, *Agency Capitalism: Further Implications of Equity Intermediation* (Colum. Law & Econ., Working Paper No. 461, 2013), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2359690.

Directors were no longer seen as entrusted with the task of making expert business decisions. Rather, they were deemed responsible for maximizing value for the shareholders. Takeovers, stock buybacks, and leverage became management's means of satisfying stock price appreciation, and stockholders—especially institutional shareholders—demanded it. Corporations were using their retained earnings and debt to return value to shareholders, to defend against hostile tender offers, or to finance takeovers. From its highs of the mid-century, internal finance gradually dropped, reaching the teens in the 1990s. Debt replaced retained earnings as corporations' main means of finance, while the stock market was becoming the principal governor of corporate behavior and stock price appreciation—an end in and of itself.⁷⁷

Seeking to constrain market demands, and perhaps stabilize a rapidly volatile stock market, progressive corporate jurists proposed allowing different stakeholders, as well as the community at large, to make demands on corporations and their managers.⁷⁸ As my class explores, the Delaware courts (and legislature) chose a different course, enabling directors and officers to exercise their power without limits. In cases addressing creditors' attempts to hold directors liable for harm to their investments, courts used the language of contracts to absolve directors from accountability to creditors, attaching fiduciary obligations to proprietary interests.⁷⁹ At the same time, as I elaborate below, while promising shareholders stock price maximization, the courts relied on the rhetoric of risk and return to justify shielding directors from liability to their shareholders, making it nearly impossible even for activist shareholders to hold management accountable.

Modern portfolio theory and the Capital Asset Pricing Model ("CAPM"), both developed in the 1950s and 1960s, helped shift academic focus from business fundamentals to the investors' ability to diversify risks inherent in particular companies (nonsystematic risks) and risks affecting the market as a whole (systematic risks). Rather than focus on the fundamentals of companies

77. Mitchell & Mitchell, *supra* note 43, at 20, 32. See also Mitchell, *supra* note 76 (providing and examining the empirical evidence supporting this argument).

78. See, e.g., Lynne L. Dallas, *Working Toward a New Paradigm*, in PROGRESSIVE CORPORATE LAW: NEW PERSPECTIVES ON LAW, CULTURE, AND SOCIETY 35, 38–40 (Lawrence E. Mitchell ed., 1995) (discussing proposed changes to corporate governance structures).

79. See, e.g., *Simons v. Cogan*, 549 A.2d 300, 303, 304 (Del. 1988). "A debenture is a credit instrument which does not devolve upon its holder an equity interest in the issuing corporation." *Id.* Similarly, a convertible debenture represented "a contractual entitlement to the repayment of a debt and . . . not . . . an equitable interest in the issuing corporation necessary for the imposition of a trust relationship with concomitant fiduciary duties." *Id.* To trigger a fiduciary duty, "an existing property right or equitable interest supporting such a duty must exist." *Id.* See also *Jedwab v. MGM Grand Hotels, Inc.*, 509 A.2d 584, 594 (Del. Ch. 1986) ("[W]ith respect to matters relating to preferences or limitations that distinguish preferred stock from common, the duty of the corporation and its directors is essentially contractual and the scope of the duty is appropriately defined by reference to the specific words evidencing that contract . . .").

in which they invested, investors were advised to study the historical performance of their companies' stock price.⁸⁰

The judiciary's embrace of CAPM happened concurrently with the development of mutual funds and the rapid growth in institutional investors' stock ownership. In *Joy v. North*, Judge Winter, writing for the Second Circuit, turned to the rhetoric of risk to justify the business judgment rule.⁸¹ Winter reasoned that shareholders voluntarily assumed the risks of business failures (and the potential for their success). Because rational shareholders would offset their exposure to business misfortunes by diversifying their portfolios (as modern finance theory dictated), corporate law did not need to protect them from such letdowns.⁸²

The Delaware courts, too, embraced the idea that the maximization of stock price was the shared goal of rational investors who, as portfolio theory suggested, could use diversification to defend against investment risks.⁸³ Take, for example, *Gagliardi v. TriFoods International, Inc.*, a case referenced in *Caremark*.⁸⁴ Shareholders, Chancellor Allen wrote in *Gagliardi*, "can diversify the risks of their corporate investments."⁸⁵ It was "[t]hus in their economic interest for the corporation to accept in rank order all positive net present value investment projects available to the corporation, starting with the *highest risk adjusted rate of return first*."⁸⁶ Given that making risky investments was in the rational investor's best interests, it was also

in the shareholders' economic interest to offer sufficient protection to directors from liability for negligence, etc., to allow directors to conclude that, as a practical matter, there is no risk that, if they act in good faith and meet minimal proceduralist standards of attention, they can face liability as a result of a business loss.⁸⁷

While *Graham* addressed directors' duties by looking at the fundamentals of the particular corporation, Allen's analysis in *Gagliardi* and *Caremark* emphasized the need to allow directors to take risks to offer higher appreciation for their stockholders and the ability of different investors to protect themselves. The rhetoric of risk and return was employed to justify protecting directors from liability.

80. See, e.g., Roberta Romano, *After the Revolution in Corporate Law*, 55 J. LEGAL EDUC. 342, 345-46 (2005) (describing the development of finance theory).

81. *Joy v. North*, 692 F.2d 880, 885-86 (2d Cir. 1982).

82. *Id.* at 886.

83. See, e.g., Romano, *supra* note 80, at 350.

84. *In re Caremark Int'l Derivative Litigation*, 698 A.2d 959, 967 (Del. Ch. 1996).

85. *Gagliardi v. TriFoods Int'l, Inc.*, 683 A.2d 1049, 1052 (Del. Ch. 1996).

86. *Id.*

87. *Id.*

In short, as the Delaware courts declared that the duty to monitor, and the duty of care more broadly, could no longer be assessed by reference to substantive, business-specific risks, they helped make the stock market the predominant tool of evaluating directors' actions and inactions. Appropriate risks were to be assessed in relationship to stock-value maximization. Corporations, Allen pronounced, should be free to take risks. If directors (and officers)

in charge of the corporation are to be adjudged personally liable for losses on the basis of a substantive judgment based upon what [] persons of ordinary or average judgment and average risk assessment talent regard as 'prudent' 'sensible' or even 'rational', such persons will have a strong incentive at the margin to authorize less risky investment projects.⁸⁸

It was a subtle, albeit significant, transition from a corporate-specific duty to market duty, substantiated by the growing impact of modern finance theory on corporate law. As the last part (or lesson) demonstrates, by the turn of the twenty-first century, the cumulative impact of these changes left the law of directors' duties muddled and increasingly immaterial.

V. DORMANT DUTIES—WHEN MARKETS AND FINANCE TRUMP LAW

Having introduced, or reintroduced, the concept of good faith as a means of resurrecting the dormant duty of care, the Delaware courts were faced with the challenge of defining the duty to act in good faith. *In re Walt Disney Co. Derivative Litigation* offered a golden opportunity to address the matter.⁸⁹ The key question in the case was whether Disney's directors breached their duties by hiring Michael Ovitz as president and firing him fourteen months later with a severance package of roughly \$130 million.⁹⁰ Earlier in the litigation, the court dismissed the duty of loyalty claims.⁹¹ At the same time, Disney's charter exempted directors from liability for breaches of the duty of care (pursuant to section 102(b)(7) of the Delaware General Corporation Law).⁹² Resurrecting a separate good faith standard was the only means of imposing liability on the board of directors. Chancellor Chandler was skillful in crafting the standard, and the Delaware Supreme Court affirmed. According to *Disney*, a director might fail to act in good faith if he or she "intentionally acts with a purpose other than that of advancing the best interests of the corporation[,] . . . acts with the intent to violate applicable positive law, or . . . intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his

88. *In re Caremark*, 698 A.2d at 968 n.16.

89. *In re Walt Disney Co. Derivative Litig.*, 907 A.2d 693 (Del. Ch. 2005), *aff'd*, 906 A.2d 27 (Del. 2006).

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

91. *In re Walt Disney Co. Derivative Litig.*, 731 A.2d 342, 380 (Del. Ch. 1998).

92. *In re Walt Disney*, 906 A.2d at 46 nn.37–38.

duties.”⁹³ The latter possibility was particularly pertinent in *Disney*, but the court, even if reluctantly, determined that the Disney directors did not fail to fulfill their duty of good faith.⁹⁴

Stone v. Ritter, involving a duty to monitor, continued to develop the contours of good faith.⁹⁵ The plaintiffs raised a “classic *Caremark* claim,” seeking to hold the directors of AmSouth Bancorporation liable for civil penalties assessed against the corporation “for operating an inadequate anti-money-laundering program” and for failing to file Suspicious Activity Reports, as required by the Federal Bank Secrecy Act.⁹⁶ Reinterpreting the *Caremark* standard after *Disney*, Justice Holland reiterated *Disney*’s definition of good faith.⁹⁷ Yet, Holland determined that the obligation to act in good faith did not establish an independent fiduciary duty; rather, it was “a condition, ‘of the fundamental duty of loyalty.’”⁹⁸ Diverging from long-standing precedent, including *Caremark*, that correctly treated the duty to monitor as a tort duty, diverging also from *Disney* that appropriately treated good faith as an independent duty, *Stone* made little conceptual sense. But, as my class concludes, it did not matter. The courts’ turn from tort and business practice to finance and the market made doctrine (and law) irrelevant.

Justice Holland reiterated *Caremark*’s conclusion that the test of liability upheld in *Stone*—“lack of good faith as evidenced by sustained or systematic failure of a director to exercise reasonable oversight”—was “quite high.”⁹⁹ In *Stone*, while the reporting system was insufficient and ineffective, the plaintiff shareholder failed to prove that the directors consciously disregarded their duty to monitor.¹⁰⁰ Yet, according to the court, the high bar was in the shareholders’ best interests. Citing again to *Caremark*, the court noted that in making “board service by qualified persons more likely, while continuing to act as a stimulus to *good faith performance of duty* by such directors[.]” it ensured that shareholders would continue to profit.¹⁰¹

In re Citigroup Shareholder Derivative Litigation came next.¹⁰² Citigroup, a global financial services company, suffered vast losses during the collapse of the housing market in 2008. In two years, Citigroup’s market capitalization was reduced from more than \$240 billion to less than \$20 billion, its stock

93. *Id.* at 67.

94. *Id.* at 67–68.

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

96. *Id.* at 364–66.

97. *Id.* at 369–70.

98. *Id.* at 370.

99. *Id.* at 372 (quoting *In re Caremark Int’l Inc. Derivative Litig.*, 698 A.2d 959, 971 (Del. Ch. 1996)).

100. *Stone*, 911 A.2d at 372–73.

101. *Id.* at 372 (quoting *Caremark*, 698 A.2d at 971).

102. *In re Citigroup Inc. S’holder Derivative Litig.*, 964 A.2d 106 (Del. Ch. 2009).

price plummeting. Many of these losses were associated with mortgage-backed securities and off-balance sheet assets.¹⁰³ Citigroup's shareholders brought an action against the company's directors and officers alleging, among others, that the defendants breached their fiduciary duties by failing properly to monitor and manage the risks associated with the subprime lending market.¹⁰⁴

Writing for Delaware's Chancery Court in the midst of the recession that followed the 2008 financial crisis, Chancellor Chandler held that Citigroup's directors and officers did not breach their fiduciary obligations. Under Delaware law, Citigroup's directors and officers could not be held liable for failing to monitor or, as Chandler described the allegations, making risky business decisions simply because their actions (or inactions) turned poor results (or financial crises).¹⁰⁵

Whether or not the plaintiffs raised a *Caremark* claim no longer mattered. *Stone* ensured that both actions and inactions of disinterested directors would be assessed using a good faith standard, now a subset of the duty of loyalty. "[O]ne can see a similarity between the standard for assessing oversight liability and the standard for assessing a disinterested director's decision under the duty of care when the company has adopted an exculpatory provision pursuant to § 102(b)(7)[,]" Chandler wrote.¹⁰⁶ To prevail in either case, a plaintiff would have to show that "a director *consciously* disregarded an obligation to be reasonably informed about the business and its risks or *consciously* disregarded the duty to monitor and oversee the business."¹⁰⁷ Like the shareholders in *Graham*, *Caremark*, and *Stone*, *Citigroup's* shareholders did not meet the burden required to impose liability on their corporation's directors.

Yet, if *Graham* focused on business practice, *Citigroup* (following *Caremark* and *Stone*) grounded good faith—the little that was left of the disinterested director's obligations—in finance. Risk, Chandler wrote, is "the chance that a return on an investment will be different tha[n] expected."¹⁰⁸ From the perspective of finance, financial institutions, just like non-financial

103. ROY C. SMITH, PAPER FORTUNES: MODERN WALL STREET: WHERE IT'S BEEN AND WHERE IT'S GOING 36–37, 347 (2009). See also Franklin A. Gevurtz, *The Role of Corporate Law in Preventing a Financial Crisis: Reflections on In re Citigroup Inc. Shareholder Derivative Litigation*, 23 PAC. MCGEORGE GLOBAL BUS. & DEV. L. J. 113, 116–17 (2010); Michelle M. Harnar, *Barriers to Effective Risk Management*, 40 SETON HALL L. REV. 1323, 1345–46 (2010); Arthur E. Wilmarth, Jr., *Citigroup: A Case Study in Managerial and Regulatory Failures*, 47 IND. L. REV. 69, 70–71, 110–11 (2014).

104. *In re Citigroup Inc. S'holder Derivative Litig.*, 964 A.2d at 111.

105. *Id.* at 139.

106. *Id.* at 125.

107. *Id.*

108. *Id.* at 126.

corporations, “make returns by taking on risk.”¹⁰⁹ In a world of “imperfect information, limited resources, and uncertain future,” the court would not, in hindsight, assess whether the directors “properly evaluated risk,” be it a risk involved in a business decision or investment.¹¹⁰ According to Chandler, to impose liability on directors “for making a ‘wrong’ business decision,” even if the decision involved monitoring, “would cripple their ability to earn returns for investors by taking business risks” and run against “bedrock principles of Delaware fiduciary duty law.”¹¹¹ “Ultimately,” Chandler wrote,

the discretion granted directors and managers allows them to maximize shareholder value in the long term by taking risks without the debilitating fear that they will be held personally liable if the company experiences losses. This doctrine also means, however, that when the company suffers losses, shareholders may not be able to hold the directors personally liable.¹¹²

In the end, the conceptual coherence of Delaware’s duty to monitor was irrelevant. In relying on different standards to assess breaches of the duty to monitor—from negligence to business judgment to good faith and finance—the Delaware courts legitimated the erosion, if not eradication, of the duty.

My class concludes the discussion of directors’ duties by reflecting upon the importance of state corporate law to the development of business. The rapid growth of the stock market in the last decades of the twentieth century and the contentment of shareholders to place their funds in the hands of corporate managers whom corporate law have shielded from liability for potential harm to the corporation seem to indicate a lack of correlation between corporate law’s regulation of the corporation’s internal affairs and the development of our market economy. History, however, suggests otherwise. That none of the cases considered as milestones in the development of the duty to monitor held directors liable for breach of such duty speaks volumes about how the courts, especially the Delaware courts, view their role. By skillfully describing directors’ duties while holding that the directors did not breach their duties, the courts conveyed a consistent message to investors about the competency and diligence of their corporations’ directors and executives. Never finding directors and executives to have breached their duties, the courts helped pacify shareholders’ concerns. With detailed analyses of the role of the board, the appropriate standard to evaluate their duties, and the theories that grounded corporate law, the courts ensured that both the defendants and the plaintiffs had their day in court, thus legitimating the development of the publicly held corporation outside the court.

109. *In re Citigroup Inc. S’holder Derivative Litig.*, 964 A.2d at 126.

110. *Id.*

111. *Id.*

112. *Id.* at 139.