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Delaware Dissolves the Glue of Capitalism: Exonerating from Claims of Incompetence Those Who Manage Other People's Money

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Delaware Dissolves the Glue of Capitalism: Exonerating from Claims of Incompetence Those Who Manage Other People's Money

Abstract

Delaware law is the leading source of non-federal law governing U.S. business organizations. Over the past 25 years that law has tilted further and further toward insulating individuals who manage business firms from any liability to the firms' owners based on claims of misconduct. These developments have occurred both in corporate law and the law of unincorporated organizations.

Although often described as consistent with market principles, these developments actually undercut the proper functioning of a market system. Effective competition among firms does not require a "dog eat dog" mentality within firms. Managerial responsibility is a prerequisite to healthy firms, which in turn are a prerequisite to a healthy market economy.

This paper explores the decay in "personal responsibility" under the Delaware law of business organizations and argues that restoring confidence to market economies requires restoring some minimum level of accountability for those who manage other people's money

Keywords

Delaware, Corporations, Corporate, Gross Negligence, Good Faith, Business Judgment, Race to the Bottom, Exoneration/Exonerate, Exculpation/Exculpate, Other People's Money, Disney, Caremark, Stone, Ritter, Lyondale

Disciplines

Organizations Law

**DELAWARE DISSOLVES THE GLUE OF CAPITALISM:
EXONERATING FROM CLAIMS OF INCOMPETENCE
THOSE WHO MANAGE OTHER PEOPLE’S MONEY**

Daniel S. Kleinberger[†]

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I. INTRODUCTION

Delaware law is the leading source of non-federal law governing U.S. business organizations.¹ Over the past twenty-five

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1. Mohsen Manesh, *Legal Asymmetry and the End of Corporate Law*, 34 DEL. J. CORP. L. 465, 476 (2009); Faith Stevelman, *Regulatory Competition, Choice of Forum, and Delaware’s Stake in Corporate Law*, 34 DEL. J. CORP. L. 57, 66–67 (2009) (“The statistics reflecting Delaware’s dominance in the chartering business are subject only to slight variation year to year. . . . Nearly sixty percent of the Fortune 500 companies and nearly the same proportion of those listed on the New York Stock Exchange are Delaware corporations. In addition, seventy percent of initial public offerings in 2004 on the New York Stock Exchange, the American Stock Exchange, and the NASDAQ were Delaware corporations. Moreover, . . . ninety-seven

years that law has tilted further and further toward insulating individuals who manage business firms from any liability to the firms' owners based on claims of incompetence.² These developments have occurred both in corporate law and the law of unincorporated organizations.³

These developments in Delaware law are often described as consistent with market principles,⁴ but excessive protection of firm managers⁵ undercuts the proper functioning of a market system. Effective competition *among* firms does not require a "dog eat dog" mentality *within* firms. Managerial responsibility is a prerequisite to healthy firms,⁶ which in turn are a prerequisite to a healthy market

percent of all U.S. public companies incorporate either in their home state or in Delaware. For firms choosing to incorporate outside their home state, eighty-five percent choose Delaware, and in total, Delaware accounts for fifty-eight percent of all U.S. public company charters. Consistent with these statistics, though scholars disagree about the reasons for and the impact of Delaware's success, its preeminence as the purveyor of nationally-relevant corporate law is beyond dispute." (footnotes omitted) (citations omitted)).

2. In the unincorporated realm, the insulation can extend to the duty of loyalty as well. *See infra* Part V. That issue is largely beyond the scope of this essay, which primarily considers insulation from claims for incompetence.

3. For an interesting assertion that, according to Delaware's constitution, the Delaware legislature cannot do what it has emphatically stated it is doing (i.e., authorize private agreements to eliminate fiduciary duty), see Lyman Johnson, *Delaware's Non-Waivable Duties*, 91 B.U. L. REV. 701 (2011).

4. Manesh, *supra* note 1, at 470 ("[C]ontractarians argue, on freedom of contract principles, that corporate law should permit shareholders to waive or modify the fiduciary duties of their corporate managers."); *see also, e.g.*, Larry E. Ribstein, *Unlimited Contracting in the Delaware Limited Partnership and Its Implications for Corporate Law*, 16 J. CORP. L. 299, 302-10 (1991) (analyzing and advocating an opt-out provision for corporations).

5. U.S. law lacks an umbrella term to encompass directors of a corporation as well as those with the highest authority in various unincorporated enterprises. This paper uses the word "manager" to indicate those persons who collectively (or, if only one person, solely): (1) determine important policies for an enterprise; (2) superintend the enterprise's overall operations; and (3) exercise ultimate and, as appropriate, active control over matters of key strategic importance to the enterprise. In this sense, directors of a corporation are managers, as are the general partners of a limited partnership, the managers of a manager-managed limited liability company, and the members of a member-managed limited liability company.

6. *See* Surendra Arjoon, *Virtue Theory as a Dynamic Theory of Business*, 28 J. BUS. ETHICS 159 (2000) (arguing that companies using ethically driven strategies perform better financially than those that use profit-driven strategies); *see also* Gabriel Flynn, *The Virtuous Manager: A Vision for Leadership in Business*, 78 J. BUS. ETHICS 359 (2008) (arguing for application of Aristotelian ethics to business management); Franco Gandolfi, *The Impact of Leadership on Health—A Preliminary Discussion*, 11 REV. INT'L COMP. MGMT. 222, 225-26 (2010), available at http://www.rmci.ase.ro/no11vol2/Vol11_No2_Article5.pdf ("[A] firm needs to

economy.⁷

This essay explores the decay in “personal responsibility” of managers under the Delaware law of business organizations and argues that one small but necessary way to restore confidence and effectiveness to the U.S. economy is to restore some minimum level of competence accountability for those who manage other people’s money.⁸

Part II states the principles of political economy and law that shape this essay’s analysis. Part III harks back to Adam Smith to make the point that managers insulated from personal liability tend toward irresponsible behavior. Part III also finds modern support for this notion across a wide spectrum of U.S. law and legal thinkers. Part IV describes the decay in personal responsibility under the Delaware corporate law applicable to directors, and Part V describes the even greater decay in the Delaware law on unincorporated business organization. Part VI notes the contemporary profusion of manuals, guides, and exhortations urging responsible, competent director behavior but argues that, with liability for incompetence almost a dead issue, all the exhortations in the world will not work.

Part VII explains the conceptual violence that Delaware has inflicted on basic entity law concepts and asserts that better liability

have a healthy mindset and a deep care for individual, group, and organizational health in order to build and secure a competitive edge for the future.”); Eliot Spitzer, *Strong Law Enforcement Is Good for the Economy*, WALL ST. J., Apr. 5, 2005, at A18, available at <http://www.happinessonline.org/InfectiousGreed/p39.htm> (arguing that strong enforcement of laws benefits the economy).

7. See Robert Ashford, *Binary Economics, Fiduciary Duties, and Corporate Social Responsibility: Comprehending Corporate Wealth Maximization and Distribution for Stockholders, Stakeholders, and Society*, 76 TUL. L. REV. 1531 (2002) (advocating inclusion of binary economics in corporate planning); Ben Bernanke, *Nonmonetary Effects of the Financial Crisis in the Propagation Mechanism of the Great Depression*, 73 AM. ECON. REV. 257 (1983) (discussing the role of bank failures in the 1930s shutdown of the banking system); Lynne L. Dallas, *A Preliminary Inquiry into the Responsibility of Corporations and Their Officers and Directors for Corporate Climate: The Psychology of Enron’s Demise*, 35 RUTGERS L.J. 1, 1 (2003) (analyzing the fallout of Enron’s bankruptcy); Kenneth Carling et al., *Exploring Relationships Between Firms’ Balance Sheets and the Macro Economy* (Oct. 1, 2003), available at <http://www.atl-res.com/finance/financeconference/jacobson.pdf> (explaining a model of the interaction of financial and macro economies).

8. Obviously, the “Debate of 2008” has multitudinous causes, many far transcending the questions discussed here. For a recent and somewhat irreverent assertion that public agencies played a major role, see J. Scott Colesanti, *Laws, Sausages, and Bailouts: Testing the Populist View of the Causes of the Economic Crisis*, 4 BROOK. J. CORP. FIN. & COM. L. 175 (2010).

rules could make use of the “best practices” admonitions to return a semblance of personal responsibility to Delaware corporate and unincorporated law. Part VIII notes that the alternative is increasing federalization of corporate governance and thus increasing over-regulation of the U.S. economy.

II. THE AUTHOR’S “PARTICULAR POINTS OF VIEW”

Max Weber, the great sociologist and social theorist, taught that “[a]ll knowledge of cultural reality . . . is always knowledge from *particular points of view*.”⁹ As a follower of Weber, I begin by stating the principal points that comprise my view of this matter:

- I support the market economy, not as a perfect or ideal mechanism, but rather in the same sense in which Winston Churchill endorsed democracy:

Many forms of Government have been tried, and will be tried in this world of sin and woe. No one pretends that democracy is perfect or all-wise. Indeed, it has been said that democracy is the worst form of Government except all those other forms that have been tried from time to time.¹⁰

- Market capitalism has its share of “sin and woe,” but centralized control has a far worse record. Compare societies that make economic decisions a species of political decision with societies that feature private accumulation of capital, private decision-making on how to deploy that capital, and an essentially free market in the resulting goods and services. The differences, throughout history, are substantial, not only in terms of economic efficiency and efficacy but also in terms of individual freedom.
- Market imperfections are inevitable, and wise and focused regulations are thus supportive of a market system. However, the more regulation shapes the process by which entrepreneurs make entrepreneurial decisions, the greater is the risk to the market system. It is one thing to decree substantively that “no corporation may dump toxic waste in the ground, water, or air.” It is quite another to control the process by which corporations make all their decisions.

9. MAX WEBER, *THE METHODOLOGY OF THE SOCIAL SCIENCES* 81 (Edward A. Shils & Henry A. Finch eds. & trans., 1949).

10. *THE YALE BOOK OF QUOTATIONS* 154 (Fred R. Shapiro ed., 2006).

Regulations of the latter type (which are increasing in the United States):

- relocate decision-making power away from firms to the government;
 - move the economy toward centralized control (no matter how large GM may be, the U.S. government is still larger); and
 - shift decision-making away from individuals with success-based incentives to individuals with bureaucratic incentives.
- As a lawyer and law professor, I am a “practical formalist.” I believe that legal constructs have practical meaning,¹¹ accumulated over time and with more or less steady usage. I believe further that recent developments in the law of business entities (especially in Delaware) have distorted some of these fundamental constructs in the guise of serving the market.
 - As a consequence of these views, I criticize changes in the dominant state law of business organizations that (1) override, distort, or reject longstanding legal constructs (2) so as to effectively immunize incompetence in those who manage other people’s property (3) with the inevitable result of calling forth more and more federal regulation of business judgment.

III. LEARNING FROM ADAM SMITH: IRRESPONSIBILITY PRODUCES IRRESPONSIBLE BEHAVIOR

In his classic work *The Wealth of Nations*, Adam Smith made an important observation as to the relationship between manager risk and manager competence. Smith was discussing the benefits and detriments of joint stock companies (with limited liability) as compared with private ventures (i.e., joint ventures and partnerships), which at that time had unlimited liability. Smith began by explaining why the joint stock company is a superior mechanism for raising capital from the public:

In a private copartnery, each partner is bound for the debts contracted by the company to the whole extent of his fortune. In a joint stock company, on the contrary, each partner is bound only to the extent of his share.

11. Practical formalism is thus quite different from what might be called a theological formalism—i.e., the belief that some transcendental meaning inheres in certain fundamental legal constructs.

The trade of a joint stock company is always managed by a court of directors. This court, indeed, is frequently subject, in many respects, to the control of a general court of proprietors. But the greater part of those proprietors seldom pretend to understand anything of the business of the company, and when the spirit of faction happens not to prevail among them, give themselves no trouble about it, but receive contentedly such half-yearly or yearly dividend as the directors think proper to make to them. This total exemption from trouble and from risk, beyond a limited sum, encourages many people to become adventurers in joint stock companies, who would, upon no account, hazard their fortunes in any private copartnery. Such companies, therefore, commonly draw to themselves much greater stocks than any private copartnery can boast of.¹²

Smith then turned to the detriments of the joint stock system, which have to do with the managers' absence of risk:

The directors of such companies, however, being the managers rather of other people's money than of their own, it cannot well be expected that they should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own. Like the stewards of a rich man, they are apt to consider attention to small matters as not for their master's honour, and very easily give themselves a dispensation from having it. Negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company.¹³

Of course, in modern economies even partnerships have liability shields for their owners,¹⁴ and virtually all economic activity occurs through shielded entities. But Smith's observation about "negligence and profusion" remains relevant. That observation extrapolates well to the increasing insulation from liability that Delaware laws provide directors and other "managers . . . of other

12. ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS bk. V, ch.1, pt. 3, art. 1, at 586 (Ward, Lock, & Tyler 1812) (1776).

13. *Id.* at 586–87.

14. UNIF. LTD. P'SHIP ACT §§ 102(9), 201(a)(4), 406(c) (2001) (providing for limited liability limited partnerships with a shield for general partners); REVISED UNIF. P'SHIP ACT §§ 306(c), 1001 (1997) (providing for limited liability partnerships).

people's money.”¹⁵

Moreover, it is a premise of modern U.S. law (outside the business entities area, perhaps) that risk of civil liability conduces individuals to careful behavior. Consider the following statements, selected to reflect a wide range of areas of law and thereby illustrate the prevalence of this risk-responsibility premise:

- “The availability of tort liability influences the behavior of potential defendants. Product manufacturers have often changed the design of their products to reduce risks, in an effort to minimize their exposure to liability. In fact, one study conducted by RAND in the early 1980s concluded that for lightly regulated manufacturers, liability was the single greatest factor influencing product design decisions. Similarly, professionals such as physicians engage in defensive practices based on the threat of liability.”¹⁶
- “If doctors know they can be sued for money damages, presumably they will be more likely to practice medicine carefully.”¹⁷
- “Copyright laws define infringing behaviors (such as unauthorized copying), and subject violators to liability. Thus, the law shapes the behavior of users of information by providing negative incentives for inefficient behavior.”¹⁸
- “The affirmative defense [to supervisor sexual harassment], which carves out an exception to a general rule of automatic liability, shapes employers' conduct.”¹⁹
- “[T]here is at least anecdotal evidence that, at the domestic level, liability claims pertaining to environmental harm have led to changes in behavior, in particular when such claims were directed against corporations (rather than states).”²⁰

15. SMITH, *supra* note 12, at 586.

16. Stephen P. Teret & Jon S. Vernick, *Gambling with the Health of Others*, 107 MICH. L. REV. FIRST IMPRESSIONS 110, 112 (2009) (arguing for tort liability for parents who fail to have their children vaccinated, thereby putting other children at risk).

17. *Hickman v. Grp. Health Plan, Inc.*, 396 N.W.2d 10, 16 (Minn. 1986) (“Presumably, too, doctors try to be careful whether or not they can be sued. But in an imperfect world, even with lawsuits, people will still be careless.”).

18. Niva Elkin-Koren, *Copyrights in Cyberspace—Rights Without Laws?*, 73 CHI.-KENT L. REV. 1155, 1157 n.5 (1998).

19. Joanna L. Grossman, *The Culture of Compliance: The Final Triumph of Form over Substance in Sexual Harassment Law*, 26 HARV. WOMEN'S L.J. 3, 8 (2003) (alteration in original).

20. Michael G. Faure & André Nollkaemper, *International Liability as an*

- “Civil liability under section 11 [of the Securities Act] and similar provisions was designed not so much to compensate the defrauded purchaser as to promote enforcement of the Act and to deter negligence by providing a penalty for those who fail in their duties.”²¹
- “Under an *ex ante* conception, the function of the insurer’s liability for bad faith [in responding to claims] is judged by the manner in which the threat of liability will affect insurer behavior. Under this conception, the threat of liability functions to correct possible underenforcement and conflict-of-interest problems. In first-party insurance, the cost to the policyholder of bringing suit for breach of contract makes it possible for the insurer to deny legitimate claims because the traditional rules governing damages award the successful claimant only the amount to which she is entitled under the policy. By threatening insurers who wrongfully deny claims with liability for extracontractual damages, bad faith liability has the potential to correct such underenforcement: Any benefit to be gained by denying a claim must be offset by the additional liability the insurer will face if it is later found to have denied the claim in ‘bad faith.’ . . . As an antidote to the traditional view of civil liability as a system of corrective justice, this modern way of thinking about civil liability from the *ex ante* perspective has been extraordinarily useful. It has encouraged judges and legal scholars to consider more carefully what has always been obvious—that liability rules not only compensate, but also deter.”²²
- “Although commentators disagree on which liability theories will best accomplish these tort goals, virtually all social engineering and ‘law and economics’ analyses share one central behavioral assumption—that imposition of liability substantially affects how categories of actors respond to the risks they create or confront.”²³
- “Economists approach civil liability as a system of incentives

Instrument to Prevent and Compensate for Climate Change, 26A STAN. ENVTL. L.J. 123, 141 (2007).

21. *Globus v. Law Research Serv., Inc.*, 418 F.2d 1276, 1288 (2d Cir. 1969) (alteration in original).

22. Kenneth S. Abraham, *The Natural History of the Insurer’s Liability for Bad Faith*, 72 TEX. L. REV. 1295, 1309, 1310–11 (1994) (alteration in original).

23. Howard A. Latin, *Problem-Solving Behavior and Theories of Tort Liability*, 73 CAL. L. REV. 677, 677 (1985).

designed to encourage or deter future behavior.”²⁴

- “[Section] 1983 [civil action for deprivation of rights under the color of law] was intended not only to provide compensation to the victims of past abuses, but to serve as a deterrent against future constitutional deprivations, as well. The knowledge that a municipality will be liable for all of its injurious conduct, whether committed in good faith or not, should create an incentive for officials who may harbor doubts about the lawfulness of their intended actions to err on the side of protecting citizens’ constitutional rights. Furthermore, the threat that damages might be levied against the city may encourage those in a policymaking position to institute internal rules and programs designed to minimize the likelihood of unintentional infringements on constitutional rights. Such procedures are particularly beneficial in preventing those ‘systemic’ injuries that result not so much from the conduct of any single individual, but from the interactive behavior of several government officials, each of whom may be acting in good faith.”²⁵

As will shortly be shown, these precepts have no place in the modern Delaware law of business organizations.

IV. THE DECAY OF PERSONAL RESPONSIBILITY IN DELAWARE CORPORATE LAW

Delaware law has always been careful about imposing liability on corporate directors. Delaware states its duty of care as the avoidance of “gross negligence” and uses the business judgment rule to reinforce the protections against personal liability for directors of Delaware corporations. Multi-volume treatises have been written on the nuance of the business judgment rule, but essentially the rule:

- obliges those with ultimate management authority to comply with the duties of loyalty and care;
- recognizes that the duty of care has both a process aspect and a substantive (or outcome) aspect but in ordinary circumstances accords minimal importance to the outcome

24. June R. Carbone & Margaret F. Brinig, *Rethinking Marriage: Feminist Ideology, Economic Change, and Divorce Reform*, 65 TUL. L. REV. 953, 954 (1991).

25. *Owen v. City of Independence*, 445 U.S. 622, 651–52 (1980) (alteration in original) (footnotes omitted) (citations omitted).

aspect²⁶; and,

- presumes that those with management authority have met their duties, thereby placing the burden of proof on plaintiffs.²⁷

The business judgment rule is intended to free entrepreneurial managers to take appropriate risks, which are necessary to survival and profitability in the “dog eat dog” world of the market. In 1982, in *Joy v. North*, Judge Ralph Winter wrote a cogent explanation and defense of the business judgment rule:

While it is often stated that corporate directors and officers will be liable for negligence in carrying out their corporate duties, all seem agreed that such a statement is misleading. Whereas an automobile driver who makes a mistake in judgment as to speed or distance injuring a pedestrian will likely be called upon to respond in damages, a corporate officer who makes a mistake in judgment as to economic conditions, consumer tastes or production line efficiency will rarely, if ever, be found liable for damages suffered by the corporation. Whatever the terminology, the fact is that liability is rarely imposed upon corporate directors or officers simply for bad judgment[,] and this reluctance to impose liability for unsuccessful business decisions has been doctrinally labelled the business judgment rule. Although the rule has suffered under academic criticism, it is not without rational basis.

First, shareholders to a very real degree voluntarily undertake the risk of bad business judgment. Investors need not buy stock, for investment markets offer an array of opportunities less vulnerable to mistakes in judgment by corporate officers. Nor need investors buy stock in particular corporations. In the exercise of what is genuinely a free choice, the quality of a firm’s management is often decisive and information is available from professional advisors. Since shareholders can and do select among investments partly on the basis of

26. Thus it is almost impossible to find an ordinary duty of care case in which the directors used acceptable process but were found wanting for having nonetheless achieved an unreasonably bad outcome. “When applying the duty of care, courts focus their inquiry on management’s efforts in arriving at the decision rather than on the wisdom of the decision itself.” 3A WILLIAM MEADE FLETCHER, FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 1036 (2002 & Supp. 2009–2010).

27. *Id.*

management, the business judgment rule merely recognizes a certain voluntariness in undertaking the risk of bad business decisions.

Second, courts recognize that after-the-fact litigation is a most imperfect device to evaluate corporate business decisions. The circumstances surrounding a corporate decision are not easily reconstructed in a courtroom years later, since business imperatives often call for quick decisions, inevitably based on less than perfect information. The entrepreneur's function is to encounter risks and to confront uncertainty, and a reasoned decision at the time made may seem a wild hunch viewed years later against a background of perfect knowledge.

Third, because potential profit often corresponds to the potential risk, it is very much in the interest of shareholders that the law not create incentives for overly cautious corporate decisions. Some opportunities offer great profits at the risk of very substantial losses, while the alternatives offer less risk of loss but also less potential profit. Shareholders can reduce the volatility of risk by diversifying their holdings. In the case of the diversified shareholder, the seemingly more risky alternatives may well be the best choice since great losses in some stocks will over time be offset by even greater gains in others. Given mutual funds and similar forms of diversified investment, courts need not bend over backwards to give special protection to shareholders who refuse to reduce the volatility of risk by not diversifying. A rule which penalizes the choice of seemingly riskier alternatives thus may not be in the interest of shareholders generally.

Whatever its merit, however, the business judgment rule extends only as far as the reasons which justify its existence. Thus, it does not apply in cases, *e.g.*, in which the corporate decision lacks a business purpose, is tainted by a conflict of interest, is so egregious as to amount to a no-win decision, or results from an obvious and prolonged failure to exercise oversight or supervision. Other examples may occur.²⁸

28. *Joy v. North*, 692 F.2d 880, 885–86 (2d Cir. 1982) (footnotes omitted) (citations omitted). The assertion that shareholders voluntarily undertake the risk of bad judgment does not delineate the extent of that risk. For example, a reasonable investor might well accept that *even given a reasonable, business-like approach to decisions, mistakes will sometimes occur* while not accepting the notion that *decision makers should be insulated from liability even if their decision making process was*

We will return to the analogy of the careless driver in Part VII, but for the moment let us add to Judge Winter's views a recent statement by E. Norman Veasey, former Chief Justice of the Delaware Supreme Court:

[T]he taking of prudent risks by directors, acting in accord with their state law fiduciary duties of care and loyalty, is the engine of business strategy and is protected by the business judgment rule. The business judgment rule is alive and well, . . . and it animates state internal corporate affairs law, as exemplified by Delaware court decisions.²⁹

In 1985, the Delaware Supreme Court caused what seemed to be a tectonic shift in the landscape of the business judgment rule, particularly the duty of care.³⁰ In *Smith v. Van Gorkom*, a case concerning a cash-out merger for an allegedly inadequate price, the court agreed with the complaining shareholders that the target's directors—"all honourable men"³¹—had abandoned their duty of care. The target was Trans Union, and its CEO and board chair, Jerome Van Gorkom, was the moving force behind the approval. According to the Delaware Supreme Court:

The directors (1) did not adequately inform themselves as to Van Gorkom's role in forcing the "sale" of the Company and in establishing the per share purchase

shoddy to the point of incompetence.

29. E. Norman Veasey, *The Challenges for Directors in Piloting Through State and Federal Standards in the Maelstrom of Risk Management*, 34 SEATTLE U. L. REV. 1, 3 (2010).

30. *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985), *overruled on other grounds* by *Gantler v. Stephens*, 965 A.2d 695, 715 n.54 (Del. 2009).

31. WILLIAM SHAKESPEARE, *JULIUS CAESAR*, act 3, sc. 2 (Antony's funeral oration). The *Van Gorkom* decision did not quote Shakespeare, but did note:

Trans Union's five "inside" directors had backgrounds in law and accounting, 116 years of collective employment by the Company and 68 years of combined experience on its Board. Trans Union's five "outside" directors included four chief executives of major corporations and an economist who was a former dean of a major school of business and chancellor of a university. The "outside" directors had 78 years of combined experience as chief executive officers of major corporations and 50 years of cumulative experience as directors of Trans Union. Thus, defendants argue that the Board was eminently qualified to reach an informed judgment on the proposed "sale" of Trans Union notwithstanding their lack of any advance notice of the proposal, the shortness of their deliberation, and their determination not to consult with their investment banker or to obtain a fairness opinion.

Van Gorkom, 488 A.2d at 880 n.21.

price; (2) were uninformed as to the intrinsic value of the Company; and (3) given these circumstances, at a minimum, were grossly negligent in approving the “sale” of the Company upon two hours’ consideration, without prior notice, and without the exigency of a crisis or emergency

[T]he Board based its September 20 decision to approve the cash-out merger primarily on Van Gorkom’s representations. None of the directors, other than Van Gorkom and Chelberg, had any prior knowledge that the purpose of the meeting was to propose a cash-out merger of Trans Union. No members of Senior Management were present, other than Chelberg, Romans and Peterson; and the latter two had only learned of the proposed sale an hour earlier. Both general counsel Moore and former general counsel Browder attended the meeting, but were equally uninformed as to the purpose of the meeting and the documents to be acted upon.

Without any documents before them concerning the proposed transaction, the members of the Board were required to rely entirely upon Van Gorkom’s 20-minute oral presentation of the proposal. No written summary of the terms of the merger was presented; the directors were given no documentation to support the adequacy of \$55 price per share for sale of the Company; and the Board had before it nothing more than Van Gorkom’s statement of his understanding of the substance of an agreement which he admittedly had never read, nor which any member of the Board had ever seen.³²

Van Gorkom was exceedingly controversial. One major corporate law savant called the decision “one of the worst decisions in the history of corporate law.”³³ Another stated that the case was “not only correctly decided, but is a sound precedent, reaffirming the basic obligation of due care owed by corporate directors to stockholders.”³⁴ Critics contended that, so long as *Van Gorkom* remained the law, qualified directors would abandon their roles almost *en masse*.

In any event, the Delaware legislature responded almost before

32. *Van Gorkom*, 488 A.2d at 874.

33. Daniel R. Fischel, *The Business Judgment Rule and the Trans Union Case*, 40 BUS. LAW. 1437, 1455 (1985).

34. William Prickett, *An Explanation of Trans Union to “Henny-Penny” and Her Friends*, 10 DELJ. CORP. L. 451, 452 (1985).

earthquake-like prophecies of doom began. As the Delaware Supreme Court later explained:

In 1986, Section 102(b)(7) was enacted by the Delaware General Assembly, following a “directors and officers insurance liability crisis and the 1985 . . . decision [of this Court] in *Smith v. Van Gorkom*.” In *Van Gorkom*, we held that directors were personally liable in monetary damages for gross negligence in the process of decisionmaking. The purpose of Section 102(b)(7) was to *permit share holders*—who are entitled to rely upon directors to discharge their fiduciary duties at all times—to adopt a provision in the certificate of incorporation to exculpate directors from any personal liability for the payment of monetary damages for breaches of their duty of care, but not for duty of loyalty violations, good faith violations and certain other conduct. Following the enactment of Section 102(b)(7), the shareholders of many Delaware corporations approved charter amendments containing these exculpatory provisions with full knowledge of their import.³⁵

The statement “with full knowledge of their import” is remarkable because it would take more than twenty years for the Delaware Supreme Court to reveal the true breadth and power of section 102(b)(7)’s exculpatory provisions.³⁶ The uncertainty—which eventually was resolved emphatically in favor of directors—had to do with the exception for “good faith violations.”³⁷ As will be seen, that resolution effectively eliminated liability for incompetence.³⁸

35. *Emerald Partners v. Berlin*, 787 A.2d 85, 90 (Del. 2001).

36. Moreover, it is questionable to what extent investors have viable choices on such matters. Consideration of that very contentious issue is beyond the scope of this essay, however.

37. *Emerald Partners*, 787 A.2d at 90.

38. Arguably, the risk of such liability was never great. Writing in 1968, Professor Joseph Bishop observed:

The hard fact is that cases in which directors of business corporations are held liable, at the suit of stockholders, for mere negligence are few and far between. As an uncommonly frank judge put it, “it is only in a most unusual and extraordinary case that directors are held liable for negligence in the absence of fraud, or improper motive, or personal interest.” The observation was made 20-odd years ago but is still valid. The ado about the liability of directors for mere negligence is like the proverbial shaving of pigs—much squeal and little wool, at least for the stockholders.

Joseph Bishop, *Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of*

Section 102(b)(7) authorizes a corporation's certificate of incorporation to contain:

A provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, provided that such provision shall not eliminate or limit the liability of a director: (i) [f]or any breach of the director's duty of loyalty to the corporation or its stockholders; (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law; (iii) under § 174 of this title [director liability for unlawful dividends]; or (iv) for any transaction from which the director derived an improper personal benefit. No such provision shall eliminate or limit the liability of a director for any act or omission occurring prior to the date when such provision becomes effective. All references in this paragraph to a director shall also be deemed to refer to such other person or persons, if any, who, pursuant to a provision of the certificate of incorporation in accordance with § 141(a) of this title [authorizing the certificate to delegate board powers and functions to "such person or persons as shall be provided in the certificate of incorporation"], exercise or perform any of the powers or duties otherwise conferred or imposed upon the board of directors by this title.³⁹

Consistent with the Delaware legislature's penchant for old-fashioned, complicated drafting,⁴⁰ section 102(b)(7) reflects the style of the "lawyer's cha-cha" (one step forward and two steps

Corporate Directors and Officers, 77 YALE L.J. 1078, 1095 (1968) (footnote omitted); see also MARK A. SARGENT & DENNIS R. HONABACH, D&O LIABILITY HANDBOOK § I:3 (footnotes omitted) ("Despite the growing sensitivity in the last three decades to the general problem of corporate governance and to the special problem of managerial responses to hostile takeovers and deep recessions, the short list of such cases compiled by Professor Bishop in 1968 has not been swelled by an influx of new decisions. The traditional judicial reticence towards validating duty of care claims persists, and the courts remain reluctant to assign personal liability to directors except in cases where there is at least an undertone of breach of the duty of loyalty.").

39. DEL. CODE ANN. tit. 8, § 102(b)(7) (2010).

40. The Delaware Supreme Court has stated of the vaunted Delaware LLC Act: "To understand the overall structure and thrust of the Act, one must wade through provisions that are prolix, sometimes oddly organized, and do not always flow evenly." *Elf Atochem N. Am., Inc. v. Jaffari*, 727 A.2d 286, 291 (Del. 1999); see also *State ex rel. Scattered Corp. v. Chicago Stock Exch., Inc.*, No. C.A. 95M-02-017-WTQ, 1996 WL 946043, at *1 n.2 (Del. Super. Ct. Feb. 23, 1996) (noting a shortcoming of "the legislative gurus of the corporate bar").

back). The section nowhere mentions the duty of care, but once the exceptions are cleared away the gravamen of the protection is clear. As explained by the Delaware Supreme Court, “[W]here the factual basis for a claim solely implicates a violation of the duty of care, this court has indicated that the protections of [a section 102(b)(7)] charter provision may properly be invoked and applied.”⁴¹ Or, as explained by two of the leading commentators on Delaware law, “[T]he purpose of § 102(b)(7) is to enable corporations to eliminate director liability for money damages for duty of care violations”⁴²

In theory, section 102(b)(7) is merely permissive. In practice, its invocation has been widespread, even ubiquitous, perhaps standard. Writing in 2005, retired Chief Justice Veasey stated: “[P]ersonal liability of directors solely for due care violations has largely become moot by reason of section 102(b)(7) of the DGCL [Delaware General Corporation Law].”⁴³

Initially, it was unclear how far section 102(b)(7) went to eliminate meaningful sanctions for incompetent behavior by directors. The pivotal question was the meaning under section 102(b)(7) of “not in good faith.”⁴⁴ Some Delaware cases referred to a “triad” of director duties—not only loyalty and care but also “good faith.”⁴⁵ Plaintiff lawyers theorized that fiduciary good faith

41. *Emerald Partners*, 726 A.2d at 1224.

42. R. FRANKLIN BALOTTI & JESSE A. FINKELSTEIN, *BALOTTI AND FINKELSTEIN’S DELAWARE LAW OF CORPORATIONS AND BUSINESS ORGANIZATIONS* § 4.13[B] (quoting *Rothenberg v. Santa Fe Pac. Corp.*, No. 11749, slip op. at 10 n.6 (Del. Ch. May 18, 1992)).

43. E. Norman Veasey & Christine T. Di Guglielmo, *What Happened in Delaware Corporate Law and Governance from 1992–2004? A Retrospective on Some Key Developments*, 153 U. PA. L. REV. 1399, 1428 (2005).

44. Almost twenty years after the enactment of section 102(b)(7), the Chancellor of the vaunted Delaware Court of Chancery “observed, after surveying the sparse case law on the subject, that both the meaning and the contours of the duty to act in good faith were ‘[s]hrouded in the fog of . . . hazy jurisprudence.’” *In re Walt Disney Co. Derivative Litig.*, 906 A.2d 27, 63 n.98 (Del. 2006) (citation omitted).

45. *E.g.*, *Emerald Partners*, 787 A.2d at 90 (“The directors of Delaware corporations have a triad of primary fiduciary duties: due care, loyalty, and good faith.”). Whatever this “good faith” meant was different than the good faith mentioned in section 141 of the Delaware Code. DEL. CODE ANN. tit. 8, § 141(e) (2010) (authorizing directors to rely “in good faith” on certain information); *see Brehm v. Eisner*, 746 A.2d 244 (Del. 2000); *see also Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 361 (Del. 1993) (“To rebut the [business judgment] rule, a shareholder plaintiff assumes the burden of providing evidence that directors, in reaching their challenged decision, breached any one of the triads of their fiduciary duty—good faith, loyalty or due care.”).

might involve some elements of at least process due care—i.e., attention to one’s task as a director. If so, there would be at least some holes in section 102(b)(7)’s insulation of incompetents.

The high water mark of this theory was the protracted *Disney* litigation. In *Brehm v. Eisner* (part of that litigation), the Delaware Supreme Court stated, “Irrationality . . . may tend to show that the decision is not made in good faith, which is a key ingredient of the business judgment rule.”⁴⁶ This statement suggested a way through the shield of section 102(b)(7). If incompetent behavior could be characterized as irrational, plaintiffs might have their day (or days) in court.

Indeed, the next time the *Disney* litigation reached the Delaware Supreme Court, the plaintiffs (appellants) asked the court “to treat a failure to exercise due care as a failure to act in good faith,” that is “to conflate these two duties and declare that a breach of the duty to be properly informed violates the duty to act in good faith.”⁴⁷ That holding would have put a major hole in the section 102(b)(7) shield, and the supreme court declined to do so.

Actually, given the particular facts of the case, the interpretative issue was moot. According to the court, even accepting appellants’ definition of good faith:

[T]he outcome would be no different, because, as the Chancellor and we now have held, the appellants failed to establish any breach of the duty of care. To say it differently, even if the Chancellor’s definition of bad faith were erroneous, the error would not be reversible because the appellants cannot satisfy the very test they urge us to adopt.⁴⁸

Undeterred by the specter of dicta, however, the court proceeded to opine on the meaning of fiduciary good faith:

[O]ur analysis of the appellants’ bad faith claim could end at this point. In other circumstances it would. This case, however, is one in which the duty to act in good faith has played a prominent role, yet to date is not a well-developed area of our corporate fiduciary law. Although the good faith concept has recently been the subject of considerable scholarly writing, which includes articles focused on this specific case, the duty to act in good faith

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

47. *In re Walt Disney*, 906 A.2d at 63.

48. *Id.*

is, up to this point[,] relatively uncharted. Because of the increased recognition of the importance of good faith, some conceptual guidance to the corporate community may be helpful. For that reason we proceed to address the merits of the appellants' second argument.⁴⁹

The court's analysis was driven by section 102(b)(7) and also section 145, which prescribes standards for indemnification and also excepts from protection actions not "in good faith." Noting a possible continuum including conduct intended to harm the corporation, gross negligence, and conscious disregard of one's duties as a director, the court stated:

Section 145, like Section 102(b)(7), evidences the intent of the Delaware General Assembly to afford significant protections to directors . . . of Delaware corporations. To adopt a definition that conflates the duty of care with the duty to act in good faith by making a violation of the former an automatic violation of the latter, would nullify those legislative protections and defeat the General Assembly's intent. There is no basis in policy, precedent or common sense that would justify dismantling⁵⁰ the distinction between gross negligence and bad faith.

The court then adopted the chancellor's non-exhaustive description of the fiduciary duty of good faith:

The good faith required of a corporate fiduciary includes not simply the duties of care and loyalty . . . but all actions

49. *Id.* at 63–64.

50. *Id.* at 66 (citations omitted). The court's conflation of sections 145 and 102(b)(7) overlooks a key distinction between the two sections. The constraints on indemnification under section 145 are greater than the constraints on exculpation under section 102(b)(7). To qualify for indemnification, a person must not only have "acted in good faith" but also "in a manner the person reasonably believed to be in or not opposed to the best interests of the corporation." DEL. CODE ANN. tit. 8, § 145(a) (2010). No such limitation exists under section 102(b)(7). Also, under section 145 a further constraint exists where the claim triggering indemnification is "by or in the right of the corporation" (the situation when a director's incompetence is at issue):

[N]o indemnification shall be made in respect of any claim, issue or matter as to which such person shall have been adjudged to be liable to the corporation unless and only to the extent that the Court of Chancery or the court in which such action or suit was brought shall determine upon application that, despite the adjudication of liability but in view of all the circumstances of the case, such person is fairly and reasonably entitled to indemnity for such expenses which the Court of Chancery or such other court shall deem proper.

Id. § 145(b). Again, section 102(b)(7) contains no comparable requirement.

required by a true faithfulness and devotion to the interests of the corporation and its shareholders. A failure to act in good faith may be shown, for instance, where the fiduciary intentionally acts with a purpose other than that of advancing the best interests of the corporation, where the fiduciary acts with the intent to violate applicable positive law, or *where the fiduciary intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties*. There may be other examples of bad faith yet to be proven or alleged, but these three are the most salient.⁵¹

Thus, as interpreted by *Disney*, section 102(b)(7) banished due care liability from Delaware corporate law—except for circumstances reminiscent of the famous widow Pritchard.⁵² The next significant “good faith” case essentially confirmed that point. In *Stone ex rel. AmSouth Bancorporation v. Ritter*, the supreme court considered the board’s oversight function, particularly the question of “assessing the liability of directors where the directors are unaware of employee misconduct that results in the corporation being held liable.”⁵³ The court approved the standard announced ten years earlier by the court of chancery in *In re Caremark International Inc. Derivative Litigation*.⁵⁴ “A ‘necessary condition’ for director oversight liability . . . [is] 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 exists.”⁵⁵

The *Stone* court went further, seeking “to clarify a doctrinal issue that is critical to understanding fiduciary liability” when the oversight duty is at issue.⁵⁶ “[A]lthough good faith may be described colloquially as part of a ‘triad’ of fiduciary duties that includes the duties of care and loyalty,”⁵⁷ strictly speaking no triad

51. *In re Walt Disney*, 906 A.2d at 67 (emphasis added).

52. Following the death of her husband, Mrs. Pritchard served along with her two sons as a director of Pritchard & Baird Intermediaries Corp., a reinsurance agency. She paid no attention whatsoever to the business. They despoiled the corporation and “spawned their fraud in the backwater of her neglect.” Francis v. United Jersey Bank, 432 A.2d 814, 829 (N.J. 1981).

53. 911 A.2d 362, 368–69 (Del. 2006).

54. 698 A.2d 959, 971 (Del. Ch. 1996).

55. *Stone*, 911 A.2d at 369 (quoting *In re Caremark Int’l Inc. Derivative Litig.*, 698 A.2d at 971).

56. *Id.* at 369.

57. *Id.* at 370.

exists. “[T]he requirement to act in good faith ‘is a subsidiary element[,]’ i.e., a condition, ‘of the fundamental duty of loyalty.’”⁵⁸ Thus, section 102(b)(7) provides a shield for incompetence, and “good faith” opens no hole in the shield unless the incompetence amounts to disloyalty.

Stone did leave one glimmer of hope for those seeking to impose liability for director incompetence: “[a] director cannot act loyally towards the corporation unless she acts in the good faith belief that her actions are in the corporation’s best interest.”⁵⁹ Thus, if shareholders could plead and eventually prove extreme incompetence, they might bring into question the “good faith” of a director’s “belief that her actions are in the corporation’s best interest.”⁶⁰ If so, the shield provided by section 102(b)(7) would yield.

However, three years after *Stone*, the Delaware Supreme Court ended that hope. *Lyondell Chemical Co. v. Ryan* involved the heightened duty of care that applies when directors arrange to sell the corporation (part of the so-called “*Revlon* duties”).⁶¹

The Court of Chancery [had] decided that “unexplained inaction” permits a reasonable inference that the directors may have consciously disregarded their fiduciary duties. The trial court expressed concern about the speed with which the transaction was consummated; the directors’ failure to negotiate better terms; and their failure to seek potentially superior deals.⁶²

Narrowly construing the directors’ *Revlon* duties, the supreme court emphatically rejected the chancery court’s understanding of “good faith”:

[T]he record establishes that the directors were disinterested and independent; that they were generally aware of the company’s value and its prospects; and that they considered the offer, under the time constraints imposed by the buyer, with the assistance of financial and

58. *Id.*

59. *Id.* (quoting *Guttman v. Huang*, 823 A.2d 492, 506 n.34 (Del. Ch. 2003)). Note that this standard is substantially laxer than the standard for indemnification under section 145. See *In re Walt Disney Co. Derivative Litig.*, 906 A.2d 27, 63–64 (Del. 2006).

60. *Stone*, 911 A.2d at 370.

61. *Lyondell Chem. Co. v. Ryan*, 970 A.2d 235, 239 (Del. 2009). The heightened duties were first announced in *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 184 (Del. 1986).

62. *Lyondell Chem. Co.*, 970 A.2d at 237.

legal advisors. At most, this record creates a triable issue of fact on the question of whether the directors exercised due care. There is no evidence, however, from which to infer that the directors knowingly ignored their responsibilities, thereby breaching their duty of loyalty. Accordingly, the directors are entitled to the entry of summary judgment.⁶³

Summary judgment was appropriate because the directors had a section 102(b)(7) shield against claims of incompetence (due care).⁶⁴ In addition, the court re-articulated the *Revlon* doctrine, rejecting the chancery court's holding that "directors must engage actively in the sale process, and they must confirm that they have obtained the best available price either by conducting an auction, by conducting a market check, or by demonstrating an impeccable knowledge of the market."⁶⁵ These specific requirements had allowed the chancery court to suppose that the "directors did not discharge that 'known set of [*Revlon*] 'duties'."⁶⁶

According to the Delaware Supreme Court, the chancery court had misunderstood the dictates of *Revlon*. "[T]here are no legally prescribed steps that directors must follow to satisfy their *Revlon* duties."⁶⁷ As a result, "the directors' failure to take any specific steps during the sale process could not have demonstrated a conscious disregard of their duties."⁶⁸ Moreover, the supreme court emphasized: "[T]here is a vast differences between an inadequate or flawed effort to carry out fiduciary duties and a conscious disregard for those duties."⁶⁹

Thus, *Lyondell* reinforced the section 102(b)(7) shield in two ways: first, the case emphasized that incompetence—no matter how serious—does not constitute a lack of good faith; second, the case made the care duties under *Revlon* far less precise, making a "conscious disregard" claim effectively impossible even in circumstances when directors know that something special (and

63. *Id.*

64. *Id.* at 239 ("Lyondell's charter includes an exculpatory provision, pursuant to 8 Del. C. § 102(b)(7), protecting the directors from personal liability for breaches of the duty of care.").

65. *Id.* at 243 (footnotes omitted) (quoting *Ryan v. Lyondell Chem. Co.* (Lyondell I), No. 3176-VCN, 2008 WL 2923427, at *12, *19 (Del. Ch. July 29, 2008)) (internal quotation marks omitted).

66. *Id.* (alteration in original) (footnote omitted) (quoting *Lyondell I* at *19).

67. *Id.*

68. *Id.*

69. *Id.*

major) is happening with the corporation.⁷⁰

In sum, twenty-five years after *Van Gorkom*, section 102(b)(7) means that there is no civil liability for extreme incompetence under Delaware corporate law, so long as the directors “go through the motions” of their tasks with sufficient visibility to negate a claim of “conscious disregard.”⁷¹ If:

- “civil liability [is] a system of incentives designed to encourage or deter future behavior”⁷²;
- the “imposition of liability substantially affects how categories of actors respond to the risks they create or confront”⁷³; and
- it is “obvious . . . that liability rules not only compensate, but also deter”⁷⁴; then it is equally obvious that the liability rules of Delaware corporate law provide no deterrence against managerial incompetence.⁷⁵

V. THE DEMISE OF FIDUCIARY DUTY IN THE DELAWARE LAW OF LIMITED LIABILITY COMPANIES AND LIMITED PARTNERSHIPS

In the United States, fiduciary duty has long been at the core of partnership law.⁷⁶ The modern U.S. limited liability company

70. See Robert B. Thompson, *The Short but Interesting Life of Good Faith as an Independent Liability Rule*, 55 N.Y.L. SCH. L. REV. 543, 544 (2010/2011) (“In a post-*Lyondell* world . . . good faith now seems orphaned in terms of having a liability function in corporate law.”).

71. The poison continues to spread. See *In re Massey Energy Co.*, No. 5430-VCS, 2011 WL 2176479, at *22 (Del. Ch. May 31, 2011) (“That reality also exists because of the *Caremark* decision itself, which our Supreme Court has embraced as setting the liability standard in this context. The *Caremark* liability standard is a high one, and requires proof that a director acted inconsistent with his fiduciary duties and, most importantly, that the director *knew* he was so acting.”); see also *In re Dow Chem. Co. Derivative Litig.*, No. 4349-CC, 2010 WL 66769, at *10 (Del. Ch. Jan. 11, 2010) (explaining that because the *Caremark* test is rooted in the concept of good faith, “plaintiffs must plead particularized facts showing bad faith”).

72. Carbone & Brinig, *supra* note 24, at 954.

73. Latin, *supra* note 23, at 677.

74. Abraham, *supra* note 22, at 1311.

75. See Jamie L. Kastler, Note, *The Problem with Waste: Delaware’s Lenient Treatment of Waste Claims at the Demand Stage of Derivative Litigation*, 95 MINN. L. REV. 1899, 1918–19 (2011) (“Delaware courts should remove the current fog of ambiguity around the waste standard and explicitly state that waste is a part of the duty of good faith. . . . An explicit ruling that places waste under good faith would provide a new mechanism for shareholders to hold directors accountable for their irrational business decisions.”). This change would be an improvement, but is not likely to occur.

76. DANIEL S. KLEINBERGER, AGENCY, PARTNERSHIPS, AND LLCs: EXAMPLES AND EXPLANATIONS §§ 9.7.2, 9.8 (3d ed. 2008); D. Gordon Smith, *The Critical Resource Theory of Fiduciary Duty*, 55 VAND. L. REV. 1399, 1458 (2002) (“[C]ourts predictably

(LLC) began as a partnership-like structure with a corporate-like liability shield,⁷⁷ and of course a limited partnership is a type of partnership.

Delaware crafted its LLC act from its limited partnership act,⁷⁸ and many early Delaware LLC cases concern issues of fiduciary duty. However, both the Delaware LLC and limited partnership statutes contain language generally embracing “freedom of contract”⁷⁹ and specifically authorizing LLC and partnership agreements to address questions of fiduciary duty.⁸⁰ Moreover, both statutes create broad exculpatory powers for LLC and partnership agreements.⁸¹

Initially, Delaware’s limited partnership and LLC statutes merely authorized a partnership or LLC agreement to *restrict* fiduciary duties, and in 2002 the Delaware Supreme Court explicitly engaged in dicta to warn that “restrict” did not entail “eliminate.”⁸² In 2004, the Delaware legislature responded, including the word “eliminate” in both statutes and also expressly authorizing broad exculpatory provisions.⁸³

impose fiduciary duties in the partnership context.”).

77. KLEINBERGER, *supra* note 76, at ch. 13.

78. CARTER G. BISHOP & DANIEL S. KLEINBERGER, LIMITED LIABILITY COMPANIES: TAX AND BUSINESS LAW ¶ 14.01[2] (1994 & Supp. 2011-1).

79. DEL. CODE ANN. tit. 6, § 17-1101(c) (2010) (“It is the policy of this chapter to give maximum effect to the principle of freedom of contract and to the enforceability of partnership agreements.”); *id.* § 18-1101(b) (2010) (same as to limited liability company agreements).

80. *Id.* § 17-1101(d) (“To the extent that, at law or in equity, a partner or other person has duties (including fiduciary duties) to a limited partnership or to another partner or to another person that is a party to or is otherwise bound by a partnership agreement, the partner’s or other person’s duties may be expanded or restricted or eliminated by provisions in the partnership agreement; provided that the partnership agreement may not eliminate the implied contractual covenant of good faith and fair dealing.”); *id.* § 18-1101(c) (same as to limited liability company agreements).

81. *Id.* § 17-1101(f) (“A partnership agreement may provide for the limitation or elimination of any and all liabilities for breach of contract and breach of duties (including fiduciary duties) of a partner or other person to a limited partnership or to another partner or to another person that is a party to or is otherwise bound by a partnership agreement; provided, that a partnership agreement may not limit or eliminate liability for any act or omission that constitutes a bad faith violation of the implied contractual covenant of good faith and fair dealing.”); *id.* § 18-1101(e) (same as to limited liability company agreements).

82. *Gotham Partners v. Hallwood Realty Partners*, 817 A.2d 160, 167–68 (Del. 2002). For a detailed discussion of this decision and the response of the Delaware legislature, see BISHOP & KLEINBERGER, *supra* note 78 ¶ 14.05[4][a][i], [ii].

83. BISHOP & KLEINBERGER, *supra* note 78 ¶ 14.05[4][a][ii].

Delaware courts still require clear language to eliminate fiduciary duties.⁸⁴ But when the language is clear, so is the effect. For example, in *Fisk Ventures v. Segal*, the court stated: “[T]he Genitrix LLC Agreement eliminates fiduciary duties to the maximum extent permitted by law by flatly stating that members have no duties other than those expressly articulated in the Agreement. Because the Agreement does not expressly articulate fiduciary obligations, they are eliminated.”⁸⁵

Likewise, Delaware courts enforce broad exculpatory provisions found in LLC and limited partnership agreements. For example, in *Wood v. Baum*, the plaintiff alleged that the directors of an LLC had breached their fiduciary duties by improperly valuing certain non-performing assets, by executing a series of “related party transactions,” and by “fail[ing] properly to institute, administer and maintain adequate accounting and reporting controls, practices and procedures,” which resulted in a ‘massive restatement process, an SEC investigation, and loss of substantial access to financial markets.’⁸⁶ The LLC’s operating agreement exculpated directors from any liability “except in the case of fraudulent or illegal conduct.”⁸⁷ The plaintiff suffered dismissal on the pleadings, unable to allege with particularity that “the directors acted with scienter, *i.e.*, that they had ‘actual or constructive knowledge’ that their conduct was legally improper.”⁸⁸

LLCs and limited partnerships rarely involve publicly traded

84. *Kelly v. Blum*, No. 4516–VCP, 2010 WL 629850, at *10 (Del. Ch. Feb. 24, 2010) (rejecting the argument of an LLC’s manager that the operating agreement, by identifying only one fiduciary duty, implicitly disclaimed the existence of any others; holding that fiduciary duties can be neither restricted nor eliminated by implication).

85. *Fisk Ventures, L.L.C. v. Segal*, No. 3017–CC, 2008 WL 1961156, at *11 (Del. Ch. May 7, 2008). The Chief Justice of the Delaware Supreme Court, Myron Steele, has argued that Delaware should by judicial decision eliminate all fiduciary duties in Delaware limited liability companies and limited partnerships. For the author’s views on that notion, see Daniel S. Kleinberger, *Why Justice Cardozo Was Right, and Chief Justice Steele Is Wrong*, INST. OF DEL. CORP. AND BUS. L. (2011), http://blogs.law.widener.edu/delcorp/?page_id=335&preview=true (article for on-line symposium hosted by the Widener Law School’s Institute of Delaware Corporate and Business Law). For other on-line symposium articles, see Symposium, *Default Fiduciary Duties in LLCs and LPs*, INST. OF DEL. CORP. AND BUS. L. (2011), <http://blogs.law.widener.edu/delcorp/on-line-symposium-default-fiduciary-duties-in-llcs-and-lps/>.

86. *Wood v. Baum*, 953 A.2d 136, 139 (Del. 2008). The discussion of this case is drawn from BISHOP & KLEINBERGER, *supra* note 78 ¶ 14.05[4][a][ii].

87. *Wood*, 953 A.2d at 139 (internal quotation marks omitted).

88. *Id.* at 141.

enterprises because most such enterprises lose the advantages of partnership tax status.⁸⁹ However, LLCs and limited partnerships play major roles in venture capital arrangements. Here, as in the corporate realm, Delaware entity law encourages managers to insulate themselves from liability for incompetent management. Indeed, the encouragement is even greater in the noncorporate realm. Under Delaware corporate law, the protection is necessarily indirect. The duty remains intact; only damage actions are blocked. In the noncorporate realm, the duty can itself be eliminated.

VI. LIABILITY (AND DETERRENCE), NO; EXHORTATION, YES

As Delaware law has increasingly disconnected managers from deterrence, would-be opinion makers have provided a wealth of advice for managers seeking competence.⁹⁰ For example, in 2003, the Director of the SEC's Division of Corporation Finance gave a speech on "[t]he importance of directors in setting the standards for and being the exemplars of good corporate governance."⁹¹ He focused in part on managerial methodology:

Devote the necessary time and prepare. An easy one. With increased duties and heightened expectations, you should make sure you have the time to be a director, and especially an audit committee member. You have to

89. BISHOP & KLEINBERGER, *supra* note 78 ¶¶ 16.01–.05. There are, however, notable exceptions. *See* Manesh, *supra* note 1, at 469 (“While almost all publicly held firms are organized as corporations, [the private equity firms of] Blackstone, Fortress, and Och-Ziff are each organized as noncorporations—a limited partnership in the case of Blackstone and limited liability companies in the cases of Fortress and Och-Ziff.”). Manesh attributes this choice of entity to the greater power to abnegate fiduciary duty. “Delaware’s noncorporate statutes permit noncorporate firms to opt out of the fiduciary regime by eliminating such duties wholesale.” *Id.* at 470.

90. REPORT OF THE NEW YORK STOCK EXCHANGE COMMISSION ON CORPORATE GOVERNANCE, NEW YORK STOCK EXCHANGE 23 (Sept. 23, 2010), <http://www.nyse.com/pdfs/CCGReport.pdf> [hereinafter NYSE REPORT] (“Given the far-reaching developments affecting corporate governance and public company disclosure during the first decade of the 21st century, it should come as no surprise that during that same time period, various organizations, coalitions and groups have released corporate governance studies, white papers, and statements of aspirational ideals of best corporate governance practices. These documents set forth certain core aspects of corporate governance, as seen by the various authoring groups.”).

91. Alan L. Beller, Dir., Div. of Corp. Fin., U.S. Sec. & Exch. Comm’n, Remarks at the Vanderbilt Directors College (June 10, 2003), in 2003 WL 21515874 (S.E.C.) at *1.

consider your other responsibilities and then decide whether you can take on the position. And the number of directors' posts you can responsibly (both to yourself and to the company) accept is now limited.

Putting in the time also means doing the work and the necessary preparation. It may sound too obvious to say, but read the disclosure documents and the other materials supplied by the company in preparation for meetings. You should also insist that the materials be provided by the company in time. Board packages, except for unavoidable last minute developments, shouldn't be provided 24 or 48 hours before the meeting anymore.⁹²

These remarks followed the enactment of the Sarbanes-Oxley Act, which had resulted from the infamous Enron scandal (and others as well). More recently, following the 2008 implosion, the New York Stock Exchange issued a lengthy report on "Corporate Governance." Among a lengthy list of recommendations for boards of directors is the following item, which carries an almost religious tone:

One fundamental role of the board is to work with the corporation's CEO to create a culture of high integrity, including adherence to both the rule of law and appropriate ethical standards. This role includes hiring the corporation's CEO and senior managers, and taking such action as is necessary to ensure that basic values such as honesty, trust, candor and transparency are maintained throughout the corporation. Insisting that the management team create a strong ethical culture is essential to proper risk management and governance.⁹³

The American Bar Association has also produced a major work on corporate governance.⁹⁴ The report includes a description of key board functions, attention to which would seem a checklist for matters a competent director will regularly consider:

Board functions that generally are retained by the board and are central to their focus include:

- Selecting, monitoring, evaluating, motivating and

92. *Id.* at *2.

93. NYSE REPORT, *supra* note 90, at 27.

94. CORP. GOVERNANCE COMM., A.B.A., REPORT OF THE TASK FORCE ON DELINEATION OF GOVERNANCE ROLES & RESPONSIBILITIES (Aug. 1, 2009), *available at* <http://apps.americanbar.org/buslaw/committees/CL260000pub/materials/20090801/delineation-final.pdf>.

compensating, and when necessary replacing the CEO and other key members of senior management;

- Monitoring corporate performance and assessing whether the corporation is being appropriately managed by the senior management team;
- Providing strategic guidance to the senior management team and reviewing and approving financial objectives and major corporate plans and actions;
- Developing corporate policy;
- Reviewing and approving major changes in auditing and accounting principles and practices;
- Overseeing audit, internal controls, risk management and ethics and compliance;
- In a public company, overseeing financial reporting and related disclosures;
- Declaring dividends and approving share repurchase programs;
- Making decisions on major transactions and other material events concerning the corporation for submission to the shareholders for approval; and
- Performing any other functions prescribed by law, regulation or listing rule, or the corporation's certificate of incorporation or bylaws.⁹⁵

The report also contains fine-sounding sentiments on director duties:

In fulfilling their mandate, directors are required to act under the high standards imposed on fiduciaries, including the duties to act with due care (focusing appropriate attention and making decisions on an informed basis), with good faith and in the best interests of the corporation and its shareholders. Directors owe duties of care and loyalty to the corporation and the shareholder body as a whole. The duty of care requires that directors inform themselves of “all material information reasonably available to them” concerning a given decision prior to acting on that decision

Directors are obligated to act in a deliberative and fully informed manner and this requires access to relevant and timely information. One of the very practical challenges in corporate governance relates to the difference between

95. *Id.* at 8–9.

managers and directors in their access to information about the corporation and the implications of this difference on the ability of part-time outside directors to hold managers accountable for the responsibilities that have been delegated to them. . . . Nonetheless, “[d]irectors must make reasonable efforts to ensure that they are being kept appropriately apprised of the company’s compliance with the law and its business performance”⁹⁶

Other examples could be easily found.⁹⁷ But to what end? If exhortation sufficed to inspire good conduct, none of us would be sinners.

Consider an analogy from the U.S. law of lawyers. For many years, the American Bar Association had a Code of Professional Responsibility, which was implemented in many states. The Code was divided into Ethical Considerations and Disciplinary Rules. The former were aspirational; violation of the latter could bring real sanctions. After much debate, the ABA eventually abandoned its dichotomous code, recognizing the aspirations without sanctions were only so much verbiage. The Code’s replacement, the Rules of Professional Conduct, contains only enforceable disciplinary rules.⁹⁸

96. *Id.* at 9 (footnotes omitted) (internal quotations marks omitted).

97. *See, e.g.*, COMM. OF SPONSORING ORGS. OF THE TREADWAY COMM’N, ENTERPRISE RISK MGMT.-INTEGRATED FRAMEWORK: EXEC. SUMMARY 2 (Sept. 2004), http://www.coso.org/Publications/ERM/COSO_ERM_ExecutiveSummary.pdf (defining enterprise risk management as “a process, effected by an entity’s board of directors, management and other personnel, applied in strategy setting and across the enterprise, designed to identify potential events that may affect the entity, and manage risk to be within its risk appetite, to provide reasonable assurance regarding the achievement of entity objectives”), *quoted in* Michelle M. Harner, *Ignoring the Writing on the Wall: The Role of Enterprise Risk Management in the Economic Crisis*, 5 J. BUS. & TECH. L. 45, 46 (2010); Tina Chi, *Corporate Governance: Boards Urged to Give Risk Oversight Duties to All Committees in Light of Dodd-Frank*, 42 SEC. REG. & L. REP. (BNA) 1948, 1948 (Oct. 18, 2010) (“In light of heightened legislative scrutiny of corporate risk oversight, all public company boards need to ensure that the responsibility for managing risks is dispersed appropriately among directors and their committees, and not unduly given to audit committees, leading corporate governance experts said Oct. 7 at a Practising Law Institute conference in New York.”).

98. Benjamin H. Barton, *The ABA, the Rules, and Professionalism: The Mechanics of Self-Defeat and a Call for a Return to the Ethical, Moral, and Practical Approach of the Canons*, 83 N.C. L. REV. 411, 421 (2005) (footnotes omitted) (describing “the ABA Code of Professional Responsibility, which separated the general (entitled ‘canons’ and ‘ethical considerations’) from the mandatory minimums (‘disciplinary rules’) and . . . the Rules of Professional Conduct, which eliminated

In a culture that generally backs competence standards with liability risks, why expect managers to respond to mere exhortation? Consider, as a further illustration, the insouciance of then Citigroup CEO, Charles Prince, when asked about liquidity risks before the bubble burst in 2008:

Regulatory agencies and industry organizations . . . began warning of liquidity issues in the financial markets in late 2006 and early 2007. When asked about these warnings, . . . Prince responded: “When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you’ve got to get up and dance. We’re still dancing”⁹⁹

So long as Delaware law insulates incompetence from liability: (1) the law encourages insouciance rather than business judgment; and (2) all the exhortations to best practices will be but a “toothless tiger.”¹⁰⁰

VII. THE CONCEPTUAL ERRORS UNDERLYING DELAWARE’S EROSION OF PERSONAL RESPONSIBILITY

Two major conceptual errors underlie the erosion of personal responsibility in the Delaware law of entities. The first involves the over-extension of contract notions, and the second involves an overly narrow conception of the law of torts.

Delaware increasingly hues to “contractarian” notions in both corporate and unincorporated law. Part V of this essay discussed the role of “freedom of contract” within LLCs and limited partnerships. In Delaware case law, that role sometimes looms so large as to obscure the fact that an LLC owes its liability shield to an act of the sovereign. For example, in *In re Seneca Investments, LLC*, the court stated that “[a]n LLC is *primarily* a creature of contract,”¹⁰¹ and in *Fisk Ventures, LLC v. Segal*, the court stated that

the broadly moral altogether”).

99. Harner, *supra* note 97, at 45 (citations omitted).

100. The Model Business Corporation Act provides another example of the dichotomy of aspirations and liability. Section 8.30 of the Model Business Corporation Act states “standards of conduct for directors,” breach of which one might expect to produce liability (assuming damages). MODEL BUS. CORP. ACT § 8.30 (2005). But “standards of liability for directors” appear separately, in section 8.31, are more lax than the conduct standards, and thus make the conduct standards merely precatory. *See id.* § 8.31.

101. *In re Seneca Invs. LLC*, 970 A.2d 259, 261 (Del. Ch. 2008) (emphasis added).

“limited liability companies . . . are creatures not of the state but of contract.”¹⁰²

The current Chief Justice of the Delaware Supreme Court is so enamored of the contractarian view of unincorporated entities that he has re-written the history of fiduciary duty. In a 2007 article, Chief Justice Steele stated:

[We must] come to grips with the reality that the contractual relationship between parties to limited partnership and limited liability company agreements should be the analytical focus for resolving governance disputes—not the status relationship of the parties. When the parties specify duties and liabilities in their agreement, the courts should resist the temptation to superimpose upon those contractual duties common law *fiduciary duty principles analogized from the law of corporate governance*.¹⁰³

But fiduciary duty within limited partnerships and LLCs does not come from corporate law. Rather, under U.S. law (including the law of Delaware), the partnership relationship has always been characterized as fiduciary.¹⁰⁴ Especially in Delaware, the LLC is in the partnership tradition, not the corporate one.¹⁰⁵ Therefore, to characterize fiduciary duties in limited partnerships and limited liability companies as an analogy from corporate governance is simply wrong.

The reach of contract into *corporation* law is illustrated in the recent case of *Nemec v. Shrader*.¹⁰⁶ The case arose when a corporation redeemed the stock of two former senior “partners” of the firm in anticipation of a major deal.¹⁰⁷ Had the former

102. *Fisk Ventures, LLC v. Segal*, No. 3017-CC, 2008 WL 1961156, at *8 (Del. Ch. May 7, 2008) (footnote omitted).

103. Myron T. Steele, *Judicial Scrutiny of Fiduciary Duties in Delaware Limited Partnerships and Limited Liability Companies*, 32 DEL. J. CORP. L. 1, 25 (2007) (emphasis added).

104. *E.g.*, *Cantor Fitzgerald, L.P. v. Cantor*, No. 16297, 2000 WL 307370, at *21–22 (Del. Ch. Mar. 13, 2000) (presupposing that general partners owe fiduciary duties; discussing when limited partners might also owe fiduciary duties); *Continental Ins. Co. v. Rutledge & Co.*, No. 15539, 1999 WL 66528, at *5 (Del. Ch. Jan. 26, 1999) (holding that the fiduciary duty inherent in a limited partnership did not arise before the formation of the partnership).

105. The Delaware LLC Act is modeled on the Delaware Limited Partnership Act. *See* BISHOP & KLEINBERGER, *supra* note 78, ¶ 14.01[2].

106. *Nemec v. Shrader*, 991 A.2d 1120 (Del. 2010).

107. *Id.* at 1123.

Booz Allen [the corporation at issue] was founded as a partnership in 1914, but later changed its legal structure and became a Delaware corporation. Booz Allen retained, however, the attitude and culture of a

“partners” remained shareholders, their payout from the deal would have been \$60 million more than the redemption price.¹⁰⁸ The “partners” alleged breach of fiduciary duty and of the contractual covenant of good faith and fair dealing.¹⁰⁹ The Delaware Supreme Court held that contract can supplant fiduciary duty, even in a purely corporate context:

It is a well-settled principle that where a dispute arises from obligations that are expressly addressed by contract, that dispute will be treated as a breach of contract claim. In that specific context, any fiduciary claims arising out of the same facts that underlie the contract obligations would be foreclosed as superfluous.¹¹⁰

The hegemony of contract is a triumph of contract over property law. The shift in perspectives means a shift in responsibilities and remedies. “Fiduciary relationships are commonly characterized by one party placing property or authority in the hands of another, or being authorized to act on behalf of the other.”¹¹¹ Once courts stop thinking about managers as handling other people’s money, the way is open to abandon “the punctilio of an honor the most sensitive” and decay into “the morals of the market place.”¹¹² As asserted in Part I, “dog eat dog” among firms may make for a competitive market. “Dog eat dog” within an entity undercuts capitalism.

The tort-related error involves a simplistic notion of negligence claims. Consider Judge Winter’s automobile analogy:

Whereas an automobile driver who makes a mistake in

partnership, owned and led by a relatively small cadre of corporate officers, who were referred to as the ‘partners.’”

Id.

108. *Id.* at 1130.

109. *Id.* at 1125.

110. *Id.* at 1129.

111. *High Valley Concrete, LLC v. Sargent*, 234 P.3d 747, 752 (Idaho 2010) (quoting *Country Cove Dev., Inc. v. May*, 150 P.3d 288, 296 (Idaho 2006)).

112. The quoted words are from Justice Cardozo’s opinion in *Meinhard v. Salmon*, 164 N.E. 545, 546 (N.Y. 1928), in which he famously distinguished between relations *inter se* co-owners of a business and relations between businesses:

Joint adventurers, like copartners, owe to one another, while the enterprise continues, the duty of the finest loyalty. Many forms of conduct permissible in a workaday world for those acting at arm’s length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior.

judgment as to speed or distance injuring a pedestrian will likely be called upon to respond in damages, a corporate officer who makes a mistake in judgment as to economic conditions, consumer tastes or production line efficiency will rarely, if ever, be found liable for damages suffered by the corporation.¹¹³

Judge Winter justifies this distinction in several ways including the inability of courts to effectively judge business judgment, the need for directors to make time-pressured decisions in conditions of imperfect information, and the fact that risk-taking is essential to profit-making.¹¹⁴ These facts argue caution in judging directors' competence but not complete abstention. In particular, these facts have little to say about judging the methodology of director decision making.

Consider another version of the automobile analogy. Suppose it is necessary that a person drive in a dangerous snowstorm. Vision will be limited, and the risks of accident are great. If the driver chooses one road over another and ends up in a ditch, we should not blame the driver. However, might we not inquire whether the driver took elementary precautions before beginning the necessarily risky journey—such as obtaining a current roadmap, making sure the car had snow tires or chains, the windshield wipers worked, and there was an adequate amount of windshield washer fluid?

While it is true that “[c]ourts are ill-fitted . . . to judge appropriate degrees of business risk,”¹¹⁵ Delaware courts in particular have fashioned several “process-related” standards for judging director methodology. For example, *Unocal Corp. v. Mesa Petroleum Co.* contains a now-venerable standard for judging the way directors decide to adopt defensive methods in the face of a possible takeover bid.¹¹⁶ *Revlon* and its progeny did likewise for directors “putting the company for sale,” at least until *Lyondell* dismantled the methodology in order to buttress section 102(b)(7).

The plethora of “best practices” documents (discussed above in Part VI) provide a starting point to return the duty of care to Delaware law. The need is not to second guess decisions but rather

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

114. *Id.* at 885–86.

115. *Brehm v. Eisner*, 746 A.2d 244, 263 (Del. 2000) (quoting *Lewis v. Vogelstein*, 699 A.2d 327, 336 (Del. Ch. 1997)).

116. 493 A.2d 946, 954–55 (Del. 1985).

to vet the process of director decision making. At least according to the New York Stock Exchange, well-meaning directors spend much time learning proper methodology:

Not surprisingly, and as with the widespread developments in law affecting governance and related disclosure obligations, corporations' management and directors have felt a need to stay current with these statements of best practices in the last decade so that they are not seen as falling behind the curve with respect to corporate governance matters. Director education programs have proliferated, in an effort to bring the classroom into the boardroom. . . .¹¹⁷

Courts should be competent to evaluate whether directors have at least managed a passing grade.¹¹⁸

VIII. THE WAGES OF SIN: INCREASING FEDERAL CONTROL OF PRIVATE DECISION-MAKING PROCESSES

Revitalizing Delaware's duty of care would require a revision to section 102(b)(7), which is exceedingly unlikely. However, the alternative will be an increasing federal intervention into corporate governance. Although Delaware's Chief Justice is sanguine about the ability of Delaware law to withstand federalization,¹¹⁹ other

117. NYSE REPORT, *supra* note 90, at 23 (footnote omitted).

118. In the words of a leading treatise on Delaware corporate law:

Even if the courts are not completely comfortable reassessing the *merits* of the directors' decision, Van Gorkom and other decisions illustrate the courts' willingness to review the *process* the directors used to reach their decision. For example, if a target board does not fully consider an offer, or if its consideration of the offer is merely a sham, a court may find that the directors violated their fiduciary duty. The courts' examination of due care focuses on a board's decision-making process: "We look for evidence as to whether a board has acted in a deliberate and knowledgeable way in identifying and exploring alternatives. Within the context of this analysis, we are, of course, ever mindful of the realities of corporate directorship."

1 R. FRANKLIN BALOTTI & JESSE A. FINKELSTEIN, BALOTTI AND FINKELSTEIN'S DELAWARE LAW OF CORPORATIONS AND BUSINESS ORGANIZATIONS § 4.15 (footnotes omitted).

119. Veasey, *supra* note 29, at 2.

The [Dodd-Frank Act] will have a sweeping regulatory effect on business, particularly banking, and will have some effect on corporate governance. Mercifully, that latter effect, in itself, will be only marginally intrusive, but nevertheless, it is a federal intrusion that is undesirable as a matter of principle. It will not, however, constitute a wholesale federal preemption of corporate law and corporate governance.

observers claim that substantial federalization has already occurred.¹²⁰ For example: “In an apparent effort to restore directors’ adherence to their fiduciary duty, Sarbanes-Oxley imposes responsibilities on directors similar to the responsibilities required under state corporate fiduciary law, appearing to ‘federalize’ that law.”¹²¹

Moreover, creative lawyers are already turning federal disclosure requirements into surrogates for state law negligence claims. In September 2010, a federal district court declined to dismiss a securities fraud claim that alleged, in essence, that AIG and its directors had mislead investors by falsely claiming managerial competence.¹²²

Id.

120. For a cynical view of what is happening, see Renee M. Jones, *The Role of Good Faith in Delaware: How Open-Ended Standards Help Delaware Preserve Its Edge*, 55 N.Y.L. SCH. L. REV. 499 (2010/2011) (recognizing a connection between Delaware’s interpretation of good faith and federal intervention).

121. Lisa M. Fairfax, *Spare the Rod, Spoil the Director? Revitalizing Directors’ Fiduciary Duty Through Legal Liability*, 42 HOUS. L. REV. 393, 400 (2005).

Sarbanes-Oxley adds teeth to the directors’ obligation by creating some greater specificity regarding this duty. Moreover, these requirements regulate the internal operations of corporate boards in a manner traditionally reserved to the states. In this way, Sarbanes-Oxley not only federalizes corporate fiduciary duties, but also adds substance to them. This federalization represents an attempt to restore directors’ fidelity to their fiduciary duties.

Id. at 404–05 (footnote omitted); see also Adam M. Fliss, *The Pendulum Swings: Federalization of Corporate Law and Its Effects on the American Capital Markets*, 41 SUFFOLK U. L. REV. 899, 899 (2008) (“Federal courts have aided Sarbanes’ intrusions into state corporate law by creating, enforcing, and broadly interpreting new rules that effectively supplant well-established state corporate law.”).

122. *In re Am. Int’l Grp., Inc. 2008 Sec. Litig.*, 741 F. Supp. 2d 511, 530–31 (S.D.N.Y. 2010). The court explained:

Plaintiffs’ allegations . . . are adequate to plead material misstatements and omissions on the part of AIG and the section 10(b) Defendants throughout the Class Period. Plaintiffs’ Complaint alleges with particularity that AIG and the section 10(b) Defendants, through AIG’s SEC filings, press releases, and investor conferences, beginning with the Company’s 2005 Form 10-K and continuing through the Company’s capital raising in May 2008, materially misled the market in the following ways: (i) failing to disclose the scope of AIGFP’s expansive underwriting of CDSs in 2005; (ii) failing to disclose that up to 75% of the cash collateral of the securities lending program was invested in RMBS; (iii) falsely stating that the Company engaged in extensive due diligence before entering into swap contracts; (iv) repeatedly emphasizing the strength of the Company’s risk controls when addressing investor concerns related to exposure to the subprime mortgage market, without disclosing that the CDS portfolio at AIGFP was in fact not subject to either the risk control processes that governed other divisions of the

In light of the radical effect of section 102(b)(7) and the “freedom of contract” excesses of Delaware’s unincorporated law, it is ironic to read a statement by Delaware’s former Chief Justice that “[t]he bottom line is that the Dodd-Frank Act does not alter or eliminate the protections *traditionally provided* to directors by the business judgment rule.”¹²³ Delaware law has gone far beyond those traditional protections, replacing fiduciary duty with contract and thereby, as a practical matter, entirely insulating those who manage other people’s money from responsibility even for sustained and substantial incompetence. The results cannot be good for a market-based economy.

Company or the risk control processes that previously had been in place at AIGFP; (v) repeatedly pronouncing confidence in the Company’s assessment of the risks presented by the CDS portfolio, despite knowledge that the Company’s models were incapable of evaluating the risks presented; (vi) stating that the Company had the ability to hedge its CDS portfolio when in fact it was not economically feasible to do so; (vii) leading investors to believe that the primary risk presented by the CDS portfolio was credit risk, when in fact the CDS portfolio entailed tremendous collateral risk and valuation risk; (viii) expressing confidence at the December 5, 2007, investor conference in their estimates related to losses in the CDS portfolio despite a warning from PwC that the Company may have a material weakness in assessing that portfolio; and (ix) leading investors to believe that the Company was raising capital in May 2008 to take advantage of opportunities in the marketplace when, in fact, the capital was necessary to meet billions of dollars’ worth of collateral obligations triggered by recent downgrades of the Company’s credit rating and the credit ratings of CDOs on which AIG had sold protection. Each of these allegations of misstatements and omissions plausibly and with particularity frames a claim of concealment of either a significant decision taken by the Company to expose itself to risk or a significant weakness in the Company’s risk controls that “would have been viewed by the reasonable investor as having significantly altered the total mix of information made available.”

Id.

123. Veasey, *supra* note 29, at 2 (emphasis added).