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## Duty of Obedience: The Forgotten Duty

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ALAN R. PALMITER

## Duty of Obedience: The Forgotten Duty

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## DUTY OF OBEDIENCE: THE FORGOTTEN DUTY

Directors and officers of for-profit corporations are said to owe two duties to the corporation: care and loyalty. But not so long ago, they also owed the corporation a “duty of obedience.” This third duty, now largely forgotten, compelled corporate fiduciaries to abide by legal norms—both those of the corporation and of external law.

In this essay, I argue that corporate law should revive (and may actually be in the process of reviving) a “duty of obedience.” Explicit recognition of such a duty would advance the legitimacy of the corporation in society. Moreover, such a duty recognizes that the duties of care and loyalty are incomplete. Corporate actions that violate legal norms, even when those actions are diligent and selfless, are inconsistent with fundamental expectations of corporate conduct.<sup>1</sup>

Recognition and development of an obedience duty would resolve much of the confusion engendered by the “duty of good faith”—a confusion consistently identified by the papers in this issue.<sup>2</sup> It would offer a clearer vocabulary for those who counsel corporate fiduciaries about their duties to abide by legal norms. It would provide a principled basis for the judicial review of internal corporate controls and corporate illegality.

The revival of the duty of obedience is not as big a stretch as might be imagined. An obedience duty has a long-standing and continuing history for fiduciaries of non-profit corporations. Non-profit trustees must abide by the legal restrictions that apply to their organizations, such as those imposed by the non-profit’s constitutive documents, any donor conditions, and restrictive tax law.

In thinking about various fiduciary cases in the for-profit corporation—many forming the canon of corporate law jurisprudence—it is clear that judges accept the duty of corporate actors to abide by legal norms. Thus, the articulated bases and results in a variety of cases hinge not only on directorial care and loyalty, but also on obedience. Were it not so, the corporation as a social institution would be in doubt.

Of course, not all disobedience by corporate actors rises to the level of a cognizable breach of corporate duty—just as not all carelessness or disloyalty is actionable. Every day, corporate decision makers make cost-benefit calculations that lead the corporation to violate legal norms: the expected business benefits are perceived to outweigh the expected legal sanctions. For example, a delivery service that double-parks its vans makes a calculation that prompt customer service is more important than snarling

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1. See generally Rob Atkinson, *Obedience as the Foundation of Fiduciary Duty*, 34 J. CORP. L. 43, 57 (2008) (distinguishing duty of obedience—to abide by limits of corporate charter—from duties of care and loyalty).
  2. See, e.g., Christopher M. Bruner, *Good Faith in Revlon-Land*, 55 N.Y.L. SCH. L. REV. 581 (2010–11) (discussing the progression of good faith and explaining how the Delaware General Corporation Law section 102(b)(7) “render[ed] uncertain the doctrinal status of good faith”); see also William W. Bratton, Lyondell: *A Note of Approbation*, 55 N.Y.L. SCH. L. REV. 561 (2010–11) (explaining that “[t]he current controversy regarding the good faith duty poses the questions whether the fiduciary standard of conduct should be brought into congruence with prevailing standards of best practice . . .”). See generally 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 (2010–11); Robert B. Thompson, *The Short, But Interesting Life of Good Faith as an Independent Liability Rule*, 55 N.Y.L. SCH. L. REV. 543 (2010–11).

traffic and risking fines. This is an inescapable aspect of living in the modern regulatory state, whether as a natural or artificial person.

Any well-formulated duty of obedience that creates internal (as opposed to external) norms of compliance must distinguish between reasonable corporate decision making to accept the risks of corporate illegality and the effrontery of pursuing an illegal course of conduct in the face of a clear, compelling legal command. While the former may deserve the same judicial abstention implied by the business judgment rule, the latter may well warrant the scrutiny and opprobrium of corporate law triggered by a shameless interested transaction.

Moreover, any obedience duty must also distinguish between the remedy of injunctive relief and one of personal liability. While *ultra vires* actions are today typically remedied by non-damages liability, as when directors' antitakeover maneuvers exceed their powers, there may be circumstances when the threat of personal liability may be necessary to ensure obedience to legal norms. The *Caremark* duty, which compels directors to create systems that monitor corporate compliance with legal norms, may represent precisely such a (mostly empty) threat.

In the end, recognizing a triumvirate of duties—care, loyalty, and obedience—serves to further legitimize and guide the modern corporation in society. The duty of obedience clarifies the role of corporate actors in ensuring corporate compliance with internal and external norms; it gives courts and other lawmakers a roadmap when faced with corporate illegality; and it offers a clearer vocabulary for those who advise corporate fiduciaries. Above all, an obedience duty serves as a reminder of the corporation's exogenous effects.

This essay proceeds in three steps. First, I describe the wavering history of the duty of obedience in the for-profit corporation, along with the duty's relationship to the *ultra vires* doctrine and thus the corporation as a social institution. Once a mainstay of corporate law, the duty of obedience now resides implicitly within the duty of good faith. Second, I look at how the obedience duty functions in the non-profit corporation, where serving social norms stands as an avowed purpose. The internalization of limited corporate purposes and external legal norms are well-established in non-profit corporate law. Third, I describe how the duty of obedience in the for-profit corporation can be and has been constructed, and suggest an explanation for many cases that fit only with difficulty in the usual care/loyalty dichotomy. The duty of obedience properly focuses the mind of corporate actors on their roles to ensure corporate legal compliance—and thus the legitimacy of the corporation.

## I. DUTY OF OBEDIENCE IN THE FOR-PROFIT CORPORATION

A duty of obedience once occupied an established place in the for-profit corporation. In his magisterial treatise on corporate law, Ballantine declared in 1946, "Directors owe a threefold duty to the corporation. First they must be obedient."<sup>3</sup> A more recent court, looking back, described the fiduciary duty triumvirate as follows:

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3. HENRY W. BALLANTINE, *BALLANTINE ON CORPORATIONS* § 62 (Revised ed. 1946) (focusing on the duties of care and loyalty).

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The duty of obedience requires a director to avoid committing ultra vires acts, i.e., acts beyond the scope of the [authority] of the corporation as defined by its [articles of incorporation] or the laws of the state of incorporation . . . . The duty of loyalty dictates that a director must act in good faith and must not allow his personal interests to prevail over the interests of the corporation . . . . [T]he duty of due care requires [that] a director must handle his corporate duties with such care as an ordinarily prudent man would use under similar circumstances.<sup>4</sup>

The duty of obedience served mostly as a natural corollary to the ultra vires doctrine. Just as the corporation was prevented from acting beyond its powers, corporate actors were obligated not to perpetrate such actions—and could be held liable if they did.<sup>5</sup> Although instances of personal liability were few, the threat was real.

Corporations, from the beginning and still today, are to engage only in “lawful business” and thus are not meant to engage in illegality.<sup>6</sup> Thus, the original ultra vires doctrine not only set the boundaries of corporate power as established by corporate norms, it also recognized that the corporation is powerless to violate non-corporate norms—that is, external law.<sup>7</sup> The obedience duty called on fiduciaries to not permit corporate illegality.

But as corporate law (and judicial review of corporate actions) moved from questions of corporate power to those of fiduciary duty, the ultra vires doctrine became largely vestigial—and its appendage, the duty of obedience, quietly wilted away. Speaking as if at a memorial service, one commentator stated:

The first of these [fiduciary duties], the duty of obedience, is not conceptually interesting and has not generated significant litigation in recent years. It merely requires directors to comply with the pertinent provisions of the articles, bylaws, and state statutory schemes.<sup>8</sup>

Today, only a handful of modern sources refer to the duty of obedience in the for-profit corporation, usually as after-thoughts. No modern for-profit corporation case has turned explicitly on the duty of obedience, though a couple of cases have made clear that directors of a subsidiary corporation need not obey directives of the parent corporation.<sup>9</sup> More significantly, no Delaware court (the font of modern corporate law) has *ever* invoked a “duty of obedience” in the for-profit corporation.<sup>10</sup>

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4. Gearhart Indus., Inc. v. Smith Int'l, Inc., 741 F.2d 707, 719–20 (5th Cir. 1984) (quoting McCollum v. Dollar, 213 S.W. 259, 261 (Tex. Comm'n App. 1919)).
  5. 3 SEYMOUR D. THOMPSON, COMMENTARIES ON THE LAW OF PRIVATE CORPORATIONS § 4019 (Bancroft-Whitney Co. 1895).
  6. DEL. CODE ANN. tit. 8, § 101(b) (2001); MODEL BUS. CORP. ACT § 3.01(a) (2002).
  7. See Kent Greenfield, *Ultra Vires Lives! A Stakeholder Analysis of Corporate Illegality (with Notes on How Corporate Law Could Reinforce International Law Norms)*, 87 VA. L. REV. 1279, 1281–82 (2001).
  8. Robert J. Wilczek, *Corporate Confidentiality: Problems and Dilemmas of Corporate Counsel*, 7 DEL. J. CORP. L. 221, 222 (1983).
  9. Deborah A. DeMott, *The Mechanisms of Control*, 13 CONN. J. INT'L L. 233, 253–54 (1999).
  10. Delaware courts have used the term “duty of obedience” in only five cases, none dealing with the duty of a corporate fiduciary to obey corporate or non-corporate norms. See *Weinstein Enters., Inc. v. Orloff*,

This is not to say that the obedience duty no longer exists. Recent courts referring to the duty of care and the duty of good faith have made clear that corporate actors cannot consciously violate—or permit the corporation to violate—corporate and non-corporate norms. Beginning with the *Allis-Chalmers* case in Delaware, courts and commentators have accepted that corporate actors may not choose to disregard non-corporate norms, even when such disregard may be profitable for the corporation.<sup>11</sup>

The landmark *Caremark* case, and the recent judicial foray into the duty of good faith, makes clear that conscious, and even negligent, disregard for non-corporate norms is antithetical to corporate law.<sup>12</sup> The source of this “duty” to ensure corporate compliance from which legal norms springs is unclear, but its existence seems beyond question.

#### *A. Original Duty of Obedience (Corollary to Ultra Vires Doctrine)*

Corporate law in the United States began as the regulation of corporate powers. Most early corporate law cases turned on whether the corporation was exercising its powers according to the governing statute and its corporate charter. Most early corporate law treatises devoted themselves extensively to questions of ultra vires.

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870 A.2d 499, 509 (Del. 2005) (rejecting that directors of a subsidiary corporation must obey the commands of the parent corporation); *Foye v. N.Y. Univ.*, 269 A.2d 63, 71 (Del. 1970) (referring to the duty of trustees of a non-profit corporation to follow corporate instructions); *In re M&F Worldwide Corp. S’holders Litig.*, 799 A.2d 1164, 1175 (Del. Ch. 2002) (referring to the duty of lawyers to obey client directives); *Cochran v. Stifel Fin. Corp.*, CA No. 17350, 2000 Del. Ch. LEXIS 58, at \*61 (Del. Ch. Mar. 8, 2000) (rejecting that directors of a subsidiary corporation must obey the commands of the parent corporation); *State ex rel. Richardson v. Swift*, 30 A. 781, 790 (Del. Super. Ct. 1885) (referring to the duty of foreign corporations to abide by the laws of the state in which they do business).

11. *See Stone v. Ritter*, 911 A.2d 362, 364–65 (Del. 2006) (stating that directors breach their duty of good faith if they “knew or should have known” of violations of law—in the case, suspicious bank transactions); *Graham v. Allis-Chalmers Mfg. Co.*, 188 A.2d 125, 130 (Del. 1963) (stating directors breach their duties by ignoring “obvious danger signs” of illegal conduct—in the case, price-fixing by employees); *In re Caremark Int’l. Inc. Derivative Litig.*, 698 A.2d 959, 971 (Del. Ch. 1996) (stating that directors breach duty of care for “sustained or systematic failure” to assure existence of reporting system to identify illegal corporate conduct—in the case, medical referral kickbacks); *see also* William S. Laufer, *Corporate Liability, Risk Shifting, and the Paradox of Compliance*, 52 VAND. L. REV. 1343, 1350 (1999) (arguing that “good corporate citizenship” has meant that “corporations simply purchase only the amount of compliance necessary to effectively shift liability away from the firm”); Hillary A. Sale, *Monitoring Caremark’s Good Faith*, 32 DEL. J. CORP. L. 719 (2007) (collecting and summarizing cases where directors were alleged to have failed to monitor illegal corporate conduct or to ensure compliance with internal corporate plans).
12. *See Caremark*, 698 A.2d at 959. This case, which arose from a settlement of allegations that directors had breached their fiduciary duties by failing to oversee the corporation’s legal compliance system, established a directorial obligation to ensure a “corporate information and reporting system” exists to provide “timely, accurate information sufficient to allow management and the board . . . to reach informed judgments concerning both the corporation’s compliance with law and its business performance.” *Id.* at 970; *see also* *Lyondell Chem. Co. v. Ryan*, 970 A.2d 235 (Del. 2009); *Stone*, 911 A.2d 362; *In re Citigroup Inc. S’holder Derivative Litig.*, 964 A.2d 106 (Del. Ch. 2009).

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In its heyday at the turn of the last century, the ultra vires doctrine provided umbrage for shareholders who sought protection from management excess—whether for acts beyond the power given to the corporation, acts that were illegal, or acts that exceeded the authority conferred by shareholders.<sup>13</sup> For example, corporate waste—corporate expenditures lacking business justification—was treated as exceeded power, not failed duty.<sup>14</sup>

Importantly, the ultra vires doctrine supplied a tool for ensuring corporate compliance with non-corporate norms. As Professor Greenfield pointed out in an article arguing for the revival of the ultra vires doctrine:

During the height of the ultra vires doctrine, a corporation's illegal activities were considered a subset of the larger category of ultra vires activities. In no sense were corporations considered as having the authority to perform illegal activities, even when performed to advance the interest of the firm.<sup>15</sup>

A commonly cited example of the application of the ultra vires doctrine—and its corollary duty of obedience to enforce non-corporate norms—is the 1909 case of *Roth v. Robertson*.<sup>16</sup> There a New York court held directors of an amusement park (Coney Island) personally liable for “hush money” paid by the corporation to avoid prosecution for violating “blue laws” that forbade business on Sunday. The court made clear that the payments were illegal, “bad in morals,” and ultra vires.<sup>17</sup>

The penalty in *Roth v. Robertson*, as well as other earlier cases in which directors permitted the corporation to exceed its powers, was personal liability, not merely an injunction against the corporate overreaching. As a 1901 treatise made clear: “All of the authorities agree that if the directors . . . do or suffer to be done acts which are beyond their powers . . . they may be compelled to make good on the loss.”<sup>18</sup>

### *B. Abandonment of the Duty of Obedience (Along with Ultra Vires Doctrine)*

But then a subtle shift began in corporate law. Instead of talking about directors being personally liable for their unauthorized actions, treatise authors began to talk about the liability of directors for failures to act responsibly—a switch from power to duty. For example, a turn-of-the-century treatise declared that if directors “attempt

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13. WILLIAM L. CLARK & WILLIAM L. MARSHALL, A TREATISE ON THE LAW OF PRIVATE CORPORATIONS §§ 204–05 (1901).

14. See *Brehm v. Eisner*, 746 A.2d 244, 263 (Del. 2000) (quoting *Lewis v. Vogelstein*, 699 A.2d 327, 336 (Del. Ch. 1997) (describing corporate waste as “an exchange of corporate assets for consideration so disproportionately small as to lie beyond the range at which any reasonable person might be willing to trade[.]” thus serving “no corporate purpose . . . in effect a gift”).

15. Greenfield, *supra* note 7, at 1314.

16. 118 N.Y.S. 351 (Sup. Ct. Erie County 1909).

17. *Id.* at 353.

18. CLARK & MARSHALL, *supra* note 13, at § 748 (citing numerous cases for the proposition).

to act beyond their powers, they may be liable to the corporation for mismanagement.”<sup>19</sup>

Another leading treatise marked the change from power to duty, observing in 1894 that “[n]o one can state with confidence what the law on [the subject of the ultra vires doctrine] is at the present time, still less predict what it will be in the near future.”<sup>20</sup> In 1927, the same treatise would conclude that the liability of directors for ultra vires acts is grounded on “violation of authority, or neglect of duty.”<sup>21</sup>

In 1946, Ballantine concluded that the duty of obedience was losing its force, explaining that, although directors and officers were liable for exceeding charter limitations on their authority, “the better view” is that they are not liable for damages if their excess was “in good faith, without negligence on their part, or if they act[ed] with the consent of the shareholders.”<sup>22</sup> The language of power had been replaced by that of duty.<sup>23</sup>

Knepper’s treatise of 1974, while echoing the existence of a triumvirate of corporate fiduciary duties, doubted that directors could be personally liable for failing to ensure corporate compliance with legal norms.<sup>24</sup> Instead, the duty of obedience had become simply a command—enforceable only by injunction to observe internal corporate norms:

While directors have been absolved from liability for permitting their corporation to engage in ultra vires acts, the general rule is that the duty of “obedience” contemplates that ultra vires corporate activities are to be avoided. Directors are supposed to contain their activities within the powers conferred upon the corporation by its charter and within the authority conferred upon them by the articles of incorporation and code of regulations.<sup>25</sup>

Today corporate law treatises no longer mention the duty of obedience.<sup>26</sup> The ALI Principles of Corporate Governance, which in the 1980s sought to summarize and guide U.S. corporate law, identified only the obligation of the *corporation* to “act within the boundaries set by law”—a notion based on “the moral norm of the

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19. *Id.* § 693, at 2108.

20. THOMPSON, *supra* note 5, § 3999, at 2907.

21. SEYMOUR D. THOMPSON, SUPPLEMENT OF 1931 TO THE COMMENTARIES ON THE LAW OF CORPORATIONS (3d ed. Supp. 1931); SEYMOUR D. THOMPSON, COMMENTARIES ON THE LAW OF CORPORATIONS (3d ed. 1927).

22. BALLANTINE, *supra* note 3, at § 65.

23. Atkinson, *supra* note 1, at 61 (concluding that “reliance on the baseline fiduciary duties of care and loyalty has tended to displace the doctrine of ultra vires in suits by shareholders against management”).

24. WILLIAM E. KNEPPER, LIABILITY OF CORPORATE OFFICERS AND DIRECTORS (2d ed. 1973).

25. *Id.* § 1.03.

26. EDWARD P. WELCH ET AL., FOLK ON THE DELAWARE GENERAL CORPORATION LAW (5th ed. 2010) does not mention the term; CORPORATE GOVERNANCE: LAW & PRACTICE (Bart Schwartz & Amy L. Goodman, eds. 2009) is also silent. *See generally* DAVID A. DREXLER ET AL., DELAWARE CORPORATION LAW AND PRACTICE (2009).



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obedience to law.”<sup>27</sup> But the ALI Principles did not go further to specify a duty of obedience for corporate actors, instead assuming only vaguely that shareholders could enforce the corporate compliance obligation, presumably by an injunctive action.<sup>28</sup>

The movement to see the corporation as private contract—and thus to delink it from non-corporate legal norms—reached its zenith with the legal contractarians.<sup>29</sup> Seeking to bury any notion that corporate law bound its actors to comply with non-corporate law, Professors Easterbrook and Fischel declared, “[m]anagers have no general obligation to avoid violating regulatory laws, when violations are profitable to the firm.”<sup>30</sup> And those who saw the corporation as a board-centric team production moved to bury any duty to comply with internal corporation norms. Professors Blair and Stout declared that, while an agent owes an obedience duty to her principal, directors in for-profit corporations “are not required to follow shareholder mandates in any way.”<sup>31</sup>

Meanwhile, corporate law reforms were busy at work to ensure that corporate law did not obligate corporate actors to comply with non-corporate legal norms. Courts (and commentators) announced a “net-loss rule” that assumed directors who permitted illegal activity could not be liable to the corporation unless the loss arising from the violation exceeded any gains the corporation garnered from the illegality—namely, a net loss.<sup>32</sup> The assumption was that only “egregious law violations involving large damages” could be actionable—though such cases never arose.<sup>33</sup>

State indemnification statutes made clear that the corporation could indemnify corporate actors against personal liability for a range of illegal acts.<sup>34</sup> State exculpation

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27. 1 AM. LAW INST., PRINCIPLES OF CORP. GOVERNANCE § 2.01, cmt. g.

28. *See id.* cmts. f–g (noting that the corporation’s obligation to observe legal norms “runs to the shareholders, rather than third parties or the state”).

29. The legal contractarian theory:

implies a theory of the role of corporate law: corporate law should merely provide a set of default rules that managers may adopt on behalf of their firms, while leaving managers free to customize their companies’ charters with legally enforceable rights and obligations. In the contractarian view, states are seen as competing with one another to attract incorporations by providing corporate law that offers value-enhancing default rules.

Michael Klausner, *The Contractarian Theory of Corporate Law: A Generation Later*, 31 J. CORP. L. 779, 780 (2006).

30. Frank H. Easterbrook & Daniel R. Fischel, *Antitrust Suits by Targets of Tender Offers*, 80 MICH. L. REV. 1155, 1168 n.36, 1177 n.57 (1982) (“Managers not only may but also should violate the rules when it is profitable to do so.”).

31. Margaret M. Blair & Lynn A. Stout, *Specific Investment: Explaining Anomalies in Corporate Law*, 31 J. CORP. L. 719, 726 (2006) (identifying the limited power of shareholders to vote their shares to elect directors and to sell their shares in the market for corporate control).

32. Greenfield, *supra* note 7, at 1299 (citing sources that describe the rule).

33. Patrick J. Ryan, *Strange Bedfellows: Corporate Fiduciaries and the General Law Compliance Obligation in Section 2.01(a) of the American Law Institute’s Principles of Corporate Governance*, 66 WASH. L. REV. 413, 495 (1991).

34. Greenfield, *supra* note 7, at 1299–300 (referencing sources that describe indemnification statutes).

statutes invited charter amendments to exculpate directors from personal liability, except in Delaware for “acts or omissions . . . which involve . . . a knowing violation of law”<sup>35</sup> and under the MBCA for “intentional violation of criminal law.”<sup>36</sup> But the duty of obedience was not dead.

*C. Revival of the Implicit Duty of Obedience (and Ultra Vires Doctrine)*

The privatization of the corporation failed. The thesis that corporate actors must ensure corporate compliance with internal and external legal norms is again well-established.<sup>37</sup> Not only have courts returned to the ultra vires doctrine to invalidate management power grabs—such as dead-hand poison pills and backdated options—they have made clear corporate actors are bound to ensure compliance with non-corporate legal norms. Corporate statutes also make clear that corporate illegality finds no comfort *under corporate law*. For example, exculpation provisions in Delaware corporations cannot absolve directors from personal liability for “a knowing violation of law.”<sup>38</sup>

A revival of the ultra vires doctrine—and implicitly the duty of obedience—has come as corporate actors have tested the outer limits of managerial power. Recent cases limiting the power of the board to disenfranchise shareholders have used the language of management power, as well as that of fiduciary duty.<sup>39</sup> Likewise, courts looking at backdated options have chastised directors for both breaching their duties of loyalty and disregarding plan limits.<sup>40</sup> Implicit in both lines of cases is the notion that corporate actors are bound to follow internal corporate norms.

Respect for internal corporate norms also undergirds the “reasonable expectations” doctrine in the close corporation.<sup>41</sup> The doctrine, by enforcing non-formalized agreements of majority and minority investors, emanates from the duty of obedience. Party expectations, akin to charter-like limitations placed on the controlling investor at the behest of the minority investor, raise questions not of care or loyalty but instead of obedience. The majority is bound to the parties’ expectations not because the majority is inattentive or uninformed, or because it is necessarily acting selfishly

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35. DEL. CODE ANN. tit. 8, § 102(b)(7)(ii) (2001).

36. MODEL BUS. CORP. ACT § 2.02(b)(4)(D) (2002).

37. Melvin A. Einsberg, *The Duty of Good Faith in Corporate Law*, 31 DEL. J. CORP. L. 1, 31 (2006) (“A well established principle under the duty of good faith is that a manager may not knowingly cause the corporation to violate the law, even when it is rational to believe that the violation would maximize corporate profits and shareholder gain . . .”).

38. *See, e.g.*, DEL. CODE ANN. tit. 8, § 102(b)(7)(ii) (2001) (permitting corporate charters to limit personal liability of directors to the corporation and its shareholders, except for “[a]cts or omissions . . . which involve . . . a knowing violation of law”).

39. *See, e.g.*, *Quickturn Design Sys., Inc. v. Shapiro*, 721 A.2d 1281, 1290–91 (Del. 1998) (holding that a delayed-redemption poison pill was beyond the board’s statutory authority and its “concomitant fiduciary duties”).

40. *See* *Ryan v. Gifford*, 918 A.2d 341 (Del. Ch. 2007).

41. *See* Robert B. Thompson, *The Shareholder’s Cause of Action for Oppression*, 48 BUS. LAW. 699, 702 (1993).

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toward the corporation, but because it has violated the agreed-upon internal norms. As Professor Atkinson has noted, “the more fundamental duty of obedience is clearly in play here. Once the minority has the majority’s commitment to a particular kind of corporate activity, that commitment must be obeyed. Conversely, departures from the specified corporate activities violate the duty of obedience.”<sup>42</sup>

The revival of a duty of obedience (though not labeled as such) has also arisen in cases that call on corporate actors to ensure compliance with internal and external non-corporate norms. The landmark case of *In re Caremark International, Inc. Derivative Litigation*, built on a revived sense of the corporation as social actor, made clear that corporate directors have duties to create and oversee compliance systems—even when there may be no net financial benefit to the corporation.<sup>43</sup> Then *Ritter v. Stone*, though re-categorizing the duty from one of care to loyalty, confirmed the fiduciary duty of corporate actors to ensure compliance.<sup>44</sup>

Admittedly, no case has imposed personal liability on directors for violating their duty to ensure legal compliance. But that duty, now buttressed by the certification and disclosure requirements of Sarbanes-Oxley,<sup>45</sup> is not without normative content. The threat of personal liability has spawned a whole industry in internal controls and a corporate aversion to being seen as consciously disregarding legal norms.<sup>46</sup>

In summary, the duty of obedience lives. But lacking a proper vocabulary, courts and commentators have gone in search for a category into which to fit it.<sup>47</sup> While *Caremark* said compliance was a matter of care and *Stone v. Ritter* said it involved good faith, a subset of loyalty, the truth is that diligence and personal fidelity in pursuit of legal compliance are simply aspects of obedience to law.

## II. DUTY OF OBEDIENCE IN THE NON-PROFIT CORPORATION

The duty of obedience has a clearer and more-established pedigree in the non-profit corporation. It is regularly mentioned along with the duties of care and loyalty. The legal literature devotes a good deal of attention to its contours and its place in non-

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42. Atkinson, *supra* note 1, at 62.

43. 698 A.2d 959 (Del. Ch. 1996).

44. 911 A.2d 362, 369–70 (Del. 2006).

45. James J. Fishman, *Improving Charitable Accountability*, 62 MD. L. REV. 218, 237–38 (2003) (discussing duty of obedience in tax context, which compels directors to ensure a non-profit corporation does not engage in prohibited lobbying activities or participate in political campaigns).

46. *Id.* (alteration in original) (footnotes omitted).

47. As Professor Eisenberg has commented:

A manager’s obligation not to knowingly cause the corporation to violate the law has traditionally and properly been founded on the duty of good faith . . . [and] cannot be founded on the duties of care and loyalty . . . Trying to squeeze such conduct into the duty of loyalty is like trying to squeeze the foot of Cinderella’s stepsister into Cinderella’s glass slipper—an enterprise equally painful and fruitless.

Eisenberg, *supra* note 37, at 38.

profit law. Court cases apply the duty to require non-profit actors to ensure compliance with the non-profit's mission, donative restrictions, and tax requirements.<sup>48</sup>

This is not surprising. The non-profit corporation exists to serve social purposes, as embodied in both internal and external norms.<sup>49</sup> Compliance with these norms is not only central to the legitimacy of the non-profit corporation, but frames the duties imposed on its actors. The non-profit vocabulary of “mission” and “trustee” suggests the degree of obedience that non-profit fiduciaries owe to the organization.<sup>50</sup>

#### A. *Scope of Non-Profit Duty of Obedience*

The leading textbook on non-profit law explains that non-profit trustees have a duty “to carry out the purposes of the organization as expressed in the articles or certificate of incorporation.”<sup>51</sup> The duty has been summarized as:

mandat[ing] that the board refrain from transactions and activities that are ultra vires, that is, beyond the corporation's powers and purposes as expressed in its certificate of incorporation . . . . Thus, the director must follow the purposes and powers expressed in the governing legal documents.<sup>52</sup>

The obedience duty therefore tracks and reinforces the non-profit's mission—“to act with fidelity, within the bounds of the law generally, to the organization's ‘mission.’”<sup>53</sup>

Commentators have also pointed out that, beyond complying with internal norms, non-profit fiduciaries also must ensure the non-profit complies with external legal regimes “ranging from federal and state tax laws, civil rights statutes, and antitrust laws which affect all organizations.”<sup>54</sup> The consequences of non-compliance by non-profit directors may be even more onerous than for their for-profit brethren:

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48. See *Summers v. Cherokee Children & Family Servs.*, 112 S.W.3d 486, 504 (Tenn. Ct. App. 2002) (quoting Harvey J. Goldschmid, *The Fiduciary Duties of Nonprofit Directors and Officers: Paradoxes, Problems, and Proposed Reforms*, 23 J. CORP. L. 631, 641 (1998)); see also *Queen of Angels Hosp. v. Younger*, 136 Cal. Rptr. 36, 39 (Cal. Ct. App. 1977); *Brown v. Mem'l Nat'l Home Found.*, 329 P.2d 118, 122 (Cal. Ct. App. 1958); *Att'y Gen. v. Hahnemann Hosp.*, 494 N.E.2d 1011, 1018 (Mass. 1986); *In re Manhattan Eye, Ear & Throat Hosp.*, 715 N.Y.S.2d 575, 595 (Sup. Ct. N.Y. County 1999) (concluding that the “duty of obedience . . . mandates that a [nonprofit] board, in the first instance, seek to preserve its original mission”).

49. See *In re Manhattan Eye, Ear & Throat Hosp.*, 715 N.Y.S.2d at 576 (blocking sale of hospital assets on grounds that it would be inconsistent with the non-profit's mission).

50. See Fishman, *supra* note 45, at 237 (noting that the duty of directors of non-profit corporations to be obedient resembles the duty of trustees to be faithful to the wishes of the trust creator).

51. JAMES J. FISHMAN & STEPHEN SCHWARZ, *NONPROFIT ORGANIZATIONS: CASES AND MATERIALS*, 219 (3d ed. 2006). Curiously, the authors also assert that the ultra vires doctrine has been emasculated in corporate law, perhaps understanding the doctrine to reach only corporate activities that conflict with charter limitations. *Id.*

52. Fishman, *supra* note 45, at 237.

53. Goldschmid, *supra* note 48, at 641 (quoting Daniel Kurtz).

54. Fishman, *supra* note 45, at 237–38 (discussing duty of obedience in tax context, which compels directors to ensure non-profit does not engage in prohibited lobbying activities or participation in political campaigns).

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A [non-profit fiduciary] can be held responsible if an organization violates the law. For example, a director or officer is liable for a corporation's failure to pay taxes if she meets the Internal Revenue Code's definition of "[responsible] person" and the failure to pay has been "willful." Directors involved in day-to-day administration of the organization in matters related to taxes and financial records are "[responsible] persons."<sup>55</sup>

Some commentators even argue that the duty of obedience "is more basic, [constituting instead] the foundation on which the duties of care and loyalty ultimately rest."<sup>56</sup> Some courts echo the view, pointing out that non-profit directors must be "principally concerned about the effective performance of the nonprofit's mission."<sup>57</sup>

Besides garnering attention from commentators, the duty of obedience has been a mainstay of non-profit case law, both as a stand-alone duty and as a subset of the duty of loyalty. A leading case, involving the proposed sale of a non-profit hospital, turned on whether the sale furthered the "purposes of the corporation."<sup>58</sup> In describing the duty to further corporate purposes, the court explained:

It is axiomatic that the Board of Directors is charged with the duty to ensure that the mission of the charitable corporation is carried out. This duty has been referred to as the "duty of obedience." It requires the director of a not-for-profit corporation to "be faithful to the purposes and goals of the organization," since "[u]nlike business corporations, whose ultimate objective is to make money, nonprofit corporations are defined by their specific objectives: perpetuation of particular activities are central to the *raison d'être* of the organization."<sup>59</sup>

The duty of obedience also requires compliance with the tax laws, which define the scope and purposes of qualifying non-profits. As the leading non-profits casebook explains:

The duty of obedience often arises in the tax context. Organizations exempt from taxation under § 501(c)(3) . . . must be organized and operated exclusively for certain approved purposes . . . . If an organization is operated for non-exempt purposes, the directors have violated their duty of obedience . . . .

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55. *Id.* at 238.

56. Atkinson, *supra* note 1, at 45.

57. Summers v. Cherokee Children & Family Servs., 112 S.W.3d 486, 504 (Tenn. Ct. App. 2002) (quoting Harvey J. Goldschmid, *The Fiduciary Duties of Nonprofit Directors and Officers: Paradoxes, Problems, and Proposed Reforms*, 23 J. CORP. L. 631, 641 (1998)); see also *Queen of Angels Hosp. v. Younger*, 136 Cal. Rptr. 36, 39 (Cal. Ct. App. 1977); *Brown v. Mem'l Nat'l Home Found.*, 329 P.2d 118, 122 (Cal. Ct. App. 1958); *Att'y Gen. v. Hahnemann Hosp.*, 494 N.E.2d 1011, 1018 (Mass. 1986); *In re Manhattan Eye, Ear & Throat Hosp. v. Spitzer*, 715 N.Y.S.2d 575, 595 (Sup. Ct. N.Y. County 1999) (concluding the "duty of obedience . . . mandates that a [non-profit] Board, in the first instance, seek to preserve its original mission").

58. *In re Manhattan Eye, Ear & Throat Hosp.*, 715 N.Y.S.2d at 575 (blocking sale of hospital assets on grounds that it would be inconsistent with the non-profit's mission).

59. *Id.* at 593 (quoting VICTORIA B. BJORKLUND ET AL., *NEW YORK NONPROFIT LAW AND PRACTICE: WITH TAX ANALYSIS* §§ 11-04, 11-51, 11-52 (2d ed. 2007)).

Directors should have in place procedures and systems that are likely to assure compliance and enable them to monitor compliance appropriately.<sup>60</sup>

In short, while an explicit duty of obedience in the for-profit corporation disappeared with the demise of the ultra vires doctrine—at least, in its old-time-religion form—the duty of obedience in the non-profit corporation continues to have vitality. It guides non-profit fiduciaries in carrying out the mission of the organization, consistent with the many legal regimes that non-profits inhabit.

*B. Survival of Obedience Duty in an Age of Non-Profit Adaptability*

The privatization movement has also seeped into the non-profit corporate world. Just as the for-profit corporation is seen as a private adaptation to the business, financial, and legal landscapes in which it operates, the non-profit corporation has come under pressure to get with the times. Old missions must be updated, dead hands must be buried, and non-profit fiduciaries must focus on the bottom line. As a recent treatise author has explained:

To the extent the duty of obedience does not carry with it a duty to assure that the trust is meeting contemporaneous needs, it does not set forth an appropriate standard.<sup>61</sup>

Thus, the duty of obedience has come under attack for limiting non-profit adaptability. The Revised Model Nonprofit Corporation Act (RMNCA), for example, does not recognize the duty of obedience in the non-profit corporation, apparently to create symmetry with its for-profit cousin.<sup>62</sup> But rather than deny the existence of a duty to comply with legal norms—the tack taken by the ALI Principles for for-profit corporations—the RMNCA assumes the duty of obedience is subsumed in the duties of care and loyalty.<sup>63</sup>

This conflation has both rhetorical and normative significance. By conflating obedience with care and loyalty, non-profit fiduciaries are told that diligence and personal fidelity are all that is expected of them.<sup>64</sup> Removing obedience from the

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60. FISHMAN & SCHWARZ, *supra* note 51, at 222.

61. MARION R. FREMONT-SMITH, *GOVERNING NONPROFIT ORGANIZATIONS: FEDERAL AND STATE LAW AND REGULATION* 226 (2004).

62. See Peggy Sasso, Comment, *Searching for Trust in the Not-for-Profit Boardroom: Looking Beyond the Duty of Obedience To Ensure Accountability*, 50 UCLA L. REV. 1485, 1522 (2003). Moreover, no non-profit statutes specifically mention a duty of obedience, though many codify the duties of care and loyalty. See Linda Sugin, *The Increasing Resemblance of Nonprofit and Business Organizations Law: Resisting the Corporatization of Nonprofit Governance: Transforming Obedience into Fidelity*, 76 FORDHAM L. REV. 893, 897 (2007).

63. See Sasso, *supra* note 62, at 1522.

64. See Nina J. Crimm, *A Case Study of a Private Foundation's Governance and Self-Interested Fiduciaries Calls for Further Regulation*, 50 EMORY L.J. 1093, 1140–42 (2001) (requiring duty of obedience, care, and loyalty of each director of nonprofit organizations); Jill S. Manny, *Governance Issues for Non-Profit Religious Organizations*, 40 CATH. LAW. 1, 20 (2000) (assuming duty of obedience is contained within duty of loyalty).

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named triumvirate makes compliance with internal and external norms easier to avoid—in the name of the non-profit carrying out the goals envisioned by current managers.

Responding to the attempt to privatize the non-profit corporation, some commentators have defended the importance of a stand-alone duty of obedience:

[I]nstead of being eliminated or collapsed under the umbrella of the duty of care, the duty of obedience should be more clearly delineated as one of the three fiduciary duties to which the not-for-profit corporate board is held, thereby sending an important message to the sector that fidelity to the institutional mission is critical.<sup>65</sup>

Some have argued that without a duty of obedience non-profit directors have no unique duty substantially different from their for-profit counterparts.<sup>66</sup> Not only does this imply application of the business judgment rule to non-profit decisions, but “the charitable corporation and the business corporation begin to look and act like each other, regardless of rhetoric and tax status.”<sup>67</sup>

Looking at the “corporatization” of non-profit governance, a recent commentator concluded:

[T]he law should include a legal requirement that directors commit themselves to an organization’s charitable mission . . . . [S]ome legal requirement is necessary and important because, without it, there is nothing in the law of nonprofit governance that affirmatively requires directors to strive for charitable goals. While loyal and careful governance, as those duties have been defined in the business context, might further a corporation’s mission, I am not convinced that they always will.<sup>68</sup>

Recent non-profit cases bolster the point. Consider the much-discussed *MEETH* case, involving a non-profit hospital in New York City that proposed to sell its facility to another hospital to be operated as a breast cancer ward and its additional land to a private real estate developer, the proceeds to fund diagnostic and treatment centers throughout the city.<sup>69</sup> In reviewing the sale, as required by New York non-profit law, the court faulted the board’s decisional process required by the duty of obedience. The court pointed out that the board had failed in its duty by seeking to “monetize the assets,” rather than to “serve the poor,” the hospital’s original mission.<sup>70</sup>

In short, the non-profit duty of obedience survives—despite recent attacks. The duty to adhere to internal norms (or the non-profit’s mission) remains a mainstay of

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65. Sasso, *supra* note 62, at 1507.

66. Melanie DiPietro, *Duty of Obedience: A Medieval Explanation for Modern Nonprofit Governance Accountability*, 46 DUQ. L. REV. 99, 102 (2007).

67. *Id.* at 102–03.

68. Linda Sugin, *Resisting the Corporatization of Nonprofit Governance: Transforming Obedience Into Fidelity*, 76 FORDHAM L. REV. 893, 904–05 (2007).

69. *In re Manhattan Eye, Ear & Throat Hosp. v. Spitzer*, 715 N.Y.S.2d 575, 582–84 (Sup. Ct. N.Y. County 1999).

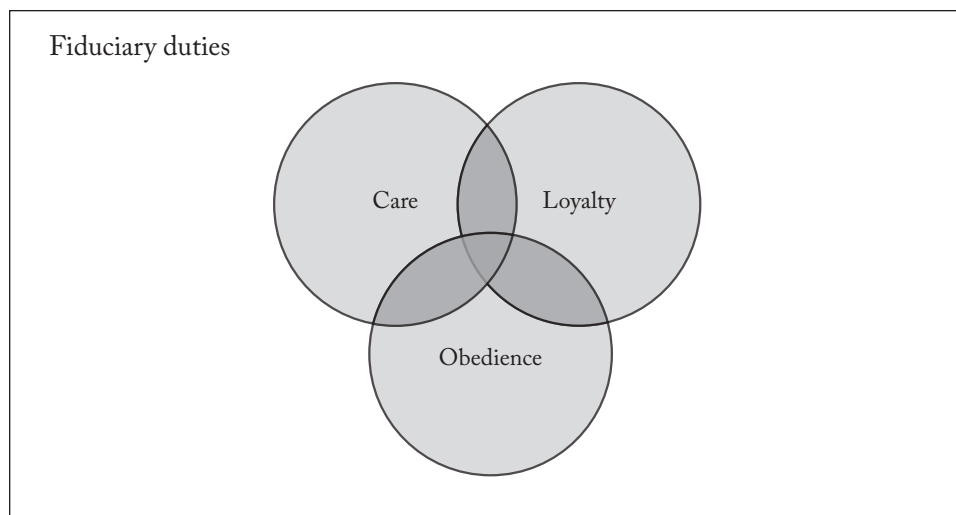
70. *See id.* at 580–84, 594–95.

the non-profit corporation, and the duty to comply with external law has not yet appeared as a target on the privatization radar screen.

### III. REVIVAL OF EXPLICIT DUTY OF OBEDIENCE IN THE FOR-PROFIT CORPORATION

Does a duty of obedience in the for-profit corporation make sense? At one level, the question is beside the point since corporate law already recognizes an implicit duty of corporate actors to comply with internal and external legal norms. More relevant is, first, whether corporate law should formally recognize such a duty and, second, how its contours should be defined.

To begin this inquiry, it is useful to cast the duty of obedience in clearer relief. The following diagram identifies the triumvirate of fiduciary duties and their overlapping coverage, using a handful of canonical cases to illustrate their operation.



Cases involving violations of corporate fiduciary duties:

1. Care only: *Smith v. Van Gorkom* (Del. 1985)
  - violation of duty of due care (gross negligence) by directors for failing to become informed about company value in a cash-out merger.<sup>71</sup>
2. Care/loyalty: *Litwin v. Allen* (Sup. Ct. N.Y. County 1940)
  - violation of duty of care (too much risk) by bank directors for approving financial transaction with corporation having conflicting ties to bank's parent.<sup>72</sup>

71. 488 A.2d 858 (Del. 1985).

72. 25 N.Y.S.2d 667 (Sup. Ct. N.Y. County 1940).



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3. Loyalty only: *Globe Woolen Co. v. Utica Gas & Electric Co.* (N.Y. 1918)
  - violation of duty of loyalty by director who failed to inform fellow directors of risk to the corporation in entering self-dealing transaction with director.<sup>73</sup>
4. Care/obedience: *McCall v. Scott* (6th Cir. 2001)
  - violation of duty of care for failing to implement internal controls that would have identified violations of Medicare and Medicaid.<sup>74</sup>
5. Loyalty/obedience: *Ryan v. Gifford* (Del. Ch. 2007)
  - violation of duty of “loyal fiduciary” for failing to comply with shareholder-approved plan for issuance of executive stock options.<sup>75</sup>
6. Obedience only: *Roth v. Robertson* (Sup. Ct. Erie County 1909)<sup>76</sup>  
*Miller v. AT&T* (3d Cir. 1974)<sup>77</sup>
  - violation of duty of obedience for approving bribes to operate an amusement park illegally on Sundays.<sup>78</sup>
  - violation of duty of obedience for failing to collect loan to political party, in violation of campaign finance laws.<sup>79</sup>
7. Care/loyalty/obedience: *In Re Enron Corp. Securities, Derivative & ERISA Litigation* (S.D. Tex. 2009)
  - violation of all three fiduciary duties for creating off-balance sheet entities while disregarding risks, for personal profit, and in violation of securities laws.<sup>80</sup>

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Without the duty of obedience, the decision whether to implement a system of internal controls would be subject only to the duty of care—and thus fall fully within the board’s informed discretion under the business judgment rule. Without obedience, the issuance of backdated stock options would involve the question of whether the corporation had gotten its money’s worth—and thus be a matter entirely of value,

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73. 224 N.Y. 483 (N.Y. 1918).

74. 239 F.3d 808, 816–17 (6th Cir. 2001).

75. 918 A.2d 341, 358 (Del. Ch. 2007).

76. 64 Misc. 343, 345 (Sup. Ct. Erie County 1909).

77. 507 F.2d 759, 761 (3d Cir. 1974).

78. *Roth*, 64 Misc. at 345.

79. *Miller*, 507 F.2d at 761.

80. 623 F. Supp. 2d 798 (S.D. Tex. 2009).

divorced from the promises implicit in the corporation's stock option plan. Without obedience, the diligent and selfless decision to violate external norms would be entirely a matter of cost-benefit analysis—and again protected by the forgiving business judgment rule.

The duty of obedience is the invisible “dark matter” of the corporate fiduciary universe, its existence inferable by imagining the universe populated only by care and loyalty as those duties are generally understood. The question then is how obedience should operate when corporate actors must decide whether to comply with *internal norms*, when called on to violate *external norms*, and when personal liability (as opposed to declaratory or injunctive relief) is sought.

#### *A. Obedience to Internal Corporate Norms*

As the ultra vires doctrine has been rediscovered, in a more subtle and textured form, so too its implicit duty of obedience. Courts speak about the limits on the power of directors to adopt takeover defenses that undercut shareholder rights—such as dead-hand poison pills and supermajority voting requirements.<sup>81</sup> And, hand in hand, directors bear a duty not to adopt such defenses.

Likewise, as corporate governance has shifted from conduct-based to disclosure-based regulation, corporate disclosures define new templates of corporate power. Courts again speak about the limits of management power when norms implicit in disclosure documents are violated—such as backdated options and other option grants.<sup>82</sup> And directors bear a duty not to permit such power excesses.

Although the line between limits imposed by power boundaries and those imposed by fiduciary duties is sometimes blurred, recent cases make clear that the ultra vires doctrine is still alive as an admonition to follow corporate statutes and corporate-specific guidelines.<sup>83</sup> And where directors stray from the template for corporate powers, there is reason (and a long tradition) for corporate law to address not only the corporation, but also its actors.

Although not yet openly tested, the duty of obedience to comply with internal corporate norms waits in the wings not only to mandate a corporate outcome (through declaratory or injunctive action), but also to impose personal liability on corporate actors who would brazenly overstep corporate norms. That is, backdating options again and again could well cross the line from poor judgment to bad judgment.

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81. See *Carmody v. Toll Bros., Inc.*, 723 A.2d 1180 (Del. Ch. 1998) (invalidating “dead hand” poison pill that could be redeemed only by the continuing directors in office when the plan was first instituted); *Chesapeake Corp. v. Shore*, 771 A.2d 293 (Del. Ch. 2000) (invalidating the bylaw that imposed supermajority voting requirements as an impediment to the shareholder franchise and disproportional takeover defense).

82. See *Ryan v. Gifford*, 918 A.2d 341 (Del. Ch. 2007) (accepting allegations of bad faith when directors approved backdated options that violated shareholder-approved stock option plan and fraudulently disclosed their compliance with the plan).

83. See *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985), *overruled in part by* *Gantler v. Stephens*, 965 A.2d 695 (Del. 2009); *McCall v. Scott*, 239 F.3d 808 (6th Cir. 2001); *Gifford*, 918 A.2d 341; *Carmody*, 723 A.2d 1180.

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The directorial duty of obedience in this context, however, need not be entirely a matter of on-off liability. It also serves an aspirational function, particularly in view of the rising phenomenon of majority-approved shareholder resolutions. Although corporate law generally constrains shareholders to phrase their views only as precatory requests, not as mandatory directives, the question of what boards of directors are to do with such requests remains open.

Certainly, just as politicians are politically compelled to consider polling data, directors act at their own political peril by disregarding precatory shareholder resolutions. The high incidence of directorial compliance with majority-approved shareholder resolutions suggests that even if there is no legally-enforceable obedience duty to abide by shareholder views, it is hard not to see an emerging and powerful corporate cultural norm.<sup>84</sup>

Thus, like the duty of care, the duty of obedience should—and already may—operate along a continuum. Blatant disregard for hard corporate norms (such as statutory commands, bylaw requirements, option plan provisos, and undertakings in disclosure documents) can lead not only to declaratory or injunctive relief, but even personal liability in extreme circumstances. Disregard for softer norms (such as precatory shareholder resolutions) constitutes the breach of an aspirational duty.

### *B. Obedience to Non-Corporate Legal Norms*

Here, the duty of obedience is called on to do yeoman's work. The ultra vires doctrine and its duty of obedience were primarily seen as means to limit the corporation to those activities envisioned first by the legislature and later by shareholders—an internal function. Although the classic doctrine makes passing references to compliance with non-corporate legal norms, this was not the original function of the duty of obedience.

Perhaps, as some have argued, extending the obedience duty to non-corporate legal norms goes too far.<sup>85</sup> The duty of obedience perhaps should be understood only to reach compliance with internal corporate norms, such as statutory restrictions or limits in the articles of incorporation. There are many problems with this argument. For one, times have changed. Modern corporate law has moved ineluctably beyond an internal ultra vires doctrine to one that also covers the corporation's obligation to comply with law—that is, one that addresses corporate externalities.

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84. See Jason M. Loring & C. Keith Taylor, *Empirical Study: Shareholder Activism: Directorial Responses to Investors' Attempts to Change the Corporate Governance Landscape*, 41 WAKE FOREST L. REV. 321, 321 (2006) (discussing the role and emerging importance of shareholder proposals).

85. If the duty of obedience were cabined, as some have suggested, to cover only compliance with internal corporate norms (such as restrictions in the articles), recognition of a separate duty might be an empty gesture. See Atkinson, *supra* note 1, at 63 (concluding that since internal norms are always modifiable by the parties, the duty of obedience “involves nothing beyond garden-variety principles of the laws of contract and agency”). But if the obedience duty reaches beyond internal norms, it becomes a positive mandate requiring affirmative obedience—precisely the holdings of *In re Caremark International, Inc. Derivative Litigation*, 698 A.2d 959 (Del. Ch. 1996) and *Stone v. Ritter*, 911 A.2d 362 (Del. 2006).

As the ultra vires doctrine has lost its central role in controlling internal conflicts, recognition of the corporation's moral obligation to comply with law has become firmly established. That is, while the doctrine has lost its preeminence, the obedience duty has grown into a powerful (if unstated) premise of the modern corporation. The obedience duty as fashioned by Delaware courts (and confirmed in Sarbanes-Oxley) reaches well beyond internal corporate norms. As *Caremark*<sup>86</sup> and *Stone*<sup>87</sup> teach, corporate actors face a positive mandate to ensure corporate compliance with external law—a duty of obedience.

Also clear in the Delaware oversight cases is that the “net loss” rule, a natural development in the corporation as private contract, is antithetical to the corporation as a social institution.<sup>88</sup> Even when illegality is profit-maximizing—either *ex ante* based on expected costs and benefits or *ex post* based on actual results—the clear consensus is that knowing violations of law are without corporate law justification.

Some have sought to explain the duty to ensure corporate legality on the ground that many shareholders (presumably full human beings) would choose corporate legality over corporate profits.<sup>89</sup> But, more critically, whatever the shareholder views on corporate legality, the corporation itself would lose its legitimacy if its governance schema called on corporate actors to violate non-corporate legal norms in the name of corporate profits. The corporation, as distrusted as ever, would lose its social standing if it openly declared itself to be an unrepentant sociopath.

So why bother with a newly reformulated duty of obedience when existing corporate duties (muddled as they are) seem to reach the same conclusions? Ultimately, despite the value of clearer judicial analysis, the vocabulary of obedience has powerful meaning. It communicates that the corporation and corporate actors serve within a larger social and legal framework. It debunks the notion—as does corporate law—that the corporation is merely a nexus of private contract.

### C. *Effect of Disobedience (Fashioning Internal Corporate Remedies)*

Corporations invariably violate the law. Should corporate actors be personally liable for allowing the corporation to violate internal and external norms? The answer, thus far, has been almost uniformly no. Although judicial rhetoric that directors are obligated to ensure corporate compliance is common, personal liability is the great exception.

It is a big step from saying that corporate actors are bound to ensure corporate compliance to saying they should face personal liability for failing to rein in corporate

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86. *Caremark*, 698 A.2d at 970–71.

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

88. See generally *Stone*, 911 A.2d at 362; *In re Walt Disney Co. Derivative Litig.*, 906 A.2d 27 (Del. 2006); *Graham v. Allis-Chalmers Mfg. Co.*, 188 A.2d 125 (Del. 1963); *Caremark*, 698 A.2d at 959.

89. See Claire A. Hill & Brett H. McDonnell, *Stone v. Ritter and the Expanding Duty of Loyalty*, 76 *FORDHAM L. REV.* 1769, 1784 (2007) (identifying corporate illegality as a category covered by the “duty of good faith,” even when director and shareholder interests may not obviously diverge, since “[i]llegal behavior may very well maximize corporate profits”).

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illegality. For this reason, perhaps, Delaware has avoided mention of an obedience duty out of a concern of *explicitly* making corporate actors responsible for compliance with non-corporate norms. After all, it's a delicate balancing job to ensure the legitimacy of the Delaware corporation, while limiting the responsibility of Delaware corporate actors.

A duty of obedience even in the context of non-corporate legal norms, however, need not imply personal liability for organizational illegality. As the Delaware courts have made clear, personal liability can attach only when (even selfless) corporate actors “consciously disregard” their duties, including their duty to monitor corporate illegality.<sup>90</sup> This would seem an acceptable compromise.

So like the duty of care, the duty of obedience may best be seen as largely aspirational. Just as corporate law calls on directors to be informed and diligent, it rarely finds sufficient fault in specific cases that would warrant crushing personal liability. And just as corporate law urges directors to observe (and have the corporation observe) corporate and non-corporate norms, directorial failures to obey have (mostly) not deserved the blunt reproach of full personal liability.

Furthermore, internal and external law is convoluted. Any meaningful duty of obedience cannot expect absolute compliance—perfection would become the enemy of the good. Just as the obedience duty in the non-profit corporation may have some room for adaptability, so too its non-profit cousin should give corporate actors a chance to test limits. Nor should every instance of noncompliance with external norms that results in fines or penalties against the corporation lead to personal liability or even a rebuke in a non-damages lawsuit.<sup>91</sup>

Just as individuals, the elemental moral actors in society, have (or should have) the freedom to make cost-benefit choices on whether to comply with legal norms, the corporation should also have some latitude. Thus, while non-compliance might result in penalties against the corporation under the applicable non-corporate legal regime, such an outcome should not necessarily demand an internal corporate settling up.

The ALI Principles make this point, contemplating that the corporation need not always comply with the law, when “the norm of obedience to law is . . . inapplicable or counterbalanced by other norms.”<sup>92</sup> For example, a public utility faced with the choice of either shutting down its plant for failure to meet a statutory clean-air deadline or continuing to generate electricity for the community it serves could choose, according to the commentary in the ALI Principles, to not comply with the deadline.

Insights in structuring a for-profit duty of obedience can be gained from the contours of the non-profit duty:

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

91. Certainly, derivative suit procedures will filter out many claims of breach of the duty of obedience. See Norwood P. Beveridge, *Does the Corporate Director Have a Duty Always to Obey the Law?*, 45 DEPAUL L. REV. 729, 732–33 (1996) (asserting that although “the traditional business judgment rule is not applied to shield directors from liability for intentional violations of law, the same result is reached indirectly through . . . the so-called ‘net-loss’ rule [and the requirement of] a pre-suit demand . . . on the board of directors, which may decide not to sue a director for past violations of law”).

92. AM. LAW INST., *supra* note 27, § 2.01 cmt. g.

The duty of obedience as suggested here gives both accountability and flexibility to a board of directors. The definitions of “mission” and “purpose” and the decisional process identified by the MEETH court give as much predictive guidance to a board of directors as the business judgment rules gives to the classical definitions of the duty of care and duty of loyalty. The retention of a duty of obedience and the application of a prudential judgment rule to a decisional process showing an evaluation of strategies to meet the pre-established and published “desired effect” of the corporation’s activities, create the frame of reference for the duties of care and loyalty. This is an efficient and economical mechanism for public accountability.<sup>93</sup>

In the for-profit corporation, communicating to corporate actors that their decisions must obey the law—subject, of course, to various ameliorating standards—has important value. The duty of obedience is a clarion reminder that we live in a well-ordered society of laws.

#### IV. CONCLUSION

The duty of obedience, once a recognized element of the for-profit corporate landscape, continues to have aspirational and normative meaning. Whether in cases applying the ultra vires doctrine to board decisions that stray beyond internal norms, statutes that mandate internal controls, or articles exculpating directors except for knowing violations of law, the duty of corporate actors to ensure legal compliance by the for-profit corporation is imbedded in corporate law. Compliance with internal corporate norms and external legal requirements is central to the legitimacy of the corporation.

So why has the duty of obedience, as such, vanished from the corporate lexicon? One explanation is that its original and principal function as a liability corollary to the ultra vires doctrine disappeared with the demise of the full-blown ultra vires doctrine. As the corporation has come to be accepted as an open-ended enterprise and questions of corporate power have been displaced by questions of fiduciary duty, the need for obedience-based liability dissolved.

Another explanation for the disappearance of obedience may come from the (temporary) rise of the theory of the corporation as a “private contract” between investors and managers. As such, corporate actors should owe no duties (beyond those specifically imposed upon them by law) to ensure corporate compliance with legal norms. But over the past two decades, a host of criminal sentencing guidelines, statutory rules, and court-created norms has roundly rejected the theory.<sup>94</sup> Today corporate actors cannot disregard internal norms or external law—except at their personal peril.

A final explanation for the disappearance of an obedience duty may be the concern that such a duty would distort, and even displace, the external norms that corporate law would be asked to enforce. For example, as illustrated by *Miller v.*

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93. DiPietro, *supra* note 66, at 132.

94. *See supra* Part III.B.

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*AT&T*, a hard duty of obedience applied to directorial non-compliance with campaign finance laws might well lead corporate law to impose greater personal liability for non-compliance than that envisioned by the campaign finance regime itself.<sup>95</sup>

All of this suggests that it may be time to recognize (and speak openly about) the animating “ghost” behind such normative regimes as the “reasonable expectations” doctrine, the binding nature of shareholder-approved compensation plans, the organizational Sentencing Guidelines, and the *Caremark* monitoring duty. Corporate actors unquestionably face “soft” duties to obey internal and external norms. Although personal liability for breaching the duty of obedience may not be a significant risk—as is also true for the duty of care—it nonetheless has real meaning.

The duties of care and loyalty—given the assumed contexts in which each arises—lack the linguistic and narrative force of a “duty of obedience.” It is no wonder, for example, that the Delaware courts have had such a hard time explaining why directors should have a duty to monitor compliance with non-corporate legal norms. *Allis-Chalmers* offered no explanation as to why directors were obligated to pay attention to “red flags”<sup>96</sup>; *Caremark* told directors the duty of care required corporate monitoring of legal compliance<sup>97</sup>; and then *Stone v. Ritter* decided the duty of good faith, a component of the duty of loyalty, required a conscious regard for legal compliance.<sup>98</sup>

The duty of obedience is part of the social contract of the corporation. The recent (though implicit) acceptance of an obedience duty arises ineluctably from the social, legal, and cultural acceptance of the “artificial person among us.” Just as we natural persons cannot remove ourselves from our legal obligations, so too the corporation and its actors derive their legitimacy from their duty to obey law.

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95. 507 F.2d 759, 762–63 (3d Cir. 1974).

96. 188 A.2d 125 (Del. 1963).

97. 698 A.2d 959, 970 (Del. Ch. 1996).

98. 911 A.2d 362, 369–70 (Del. 2006).