
FIDUCIARY CONSTRAINTS: CORRELATING OBLIGATION WITH LIABILITY

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I. INTRODUCTION

The business scandals involving wrongdoing such as financial fraud and stock option backdating have given rise to demands that officers and executives be held accountable. The Sarbanes-Oxley legislation (“SOX”)¹ has imposed additional obligations on CEOs and CFOs, not only to certify the accuracy of financial statements,² but to also attest to the veracity of internal controls.³ Corporations are now required to disclose whether the audit committee includes a financial expert.⁴ Although federal law explicitly provides that the financial expert of the audit committee does not risk increased liability under securities laws as an expert,⁵ it is not clear that state law will be so lenient.

Indeed, state law seems to be ratcheting up the scrutiny of corporate behavior, including the behavior of officers and executives. Fiduciary obligation has long served as state corporate law’s primary constraint on director behavior. Fiduciary principles have proven to be flexible in adapting to the evolving business landscape. State corporate law fiduciary principles are less well developed,

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1. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002) (codified as amended in scattered sections of 11, 15, 18, 28, and 29 U.S.C.).

2. *Id.* § 302.

3. *Id.*

4. *Id.* § 407.

5. 17 C.F.R. §§ 228, 229, 249 (2006).

though, outside the board of directors context.

In this Article, we consider the issues that are likely to arise as officer conduct is scrutinized more closely using state corporate fiduciary principles. The challenge is not so much ensuring that fiduciary principles govern the conduct of corporate actors as it is correlating obligation with potential liability. Under basic agency law, all corporate agents owe fiduciary obligations. But, other than in clear examples such as the theft of a corporate opportunity, there is surprisingly little in the way of law on the analysis used to consider the liability of officers for fiduciary breach or whether the business judgment rule protects their decisions. Application of fiduciary standards to officers and executives may require some reshaping of the considerations given to conflicts of interest.

An issue of scope also exists. If fiduciary responsibility gains a more prominent role in the regulation of corporate officer behavior, and if all corporate officers are fiduciaries, then principles are needed to cabin the scope of responsibility and liability of each individual officer. To further define the challenges that corporate law is likely to confront as it attempts to link individual officer liability and wrongdoing, we turn to federal law.

It is not difficult to think of federal statutes, such as the Sarbanes-Oxley Act of 2002,⁶ the Securities Act of 1933,⁷ and the Securities Exchange Act of 1934,⁸ when considering the federal constraints on modern corporate executives of public companies.⁹ Unlike state corporate law, though, none of these statutes are grounded in fiduciary principles. Instead, these statutes generally operate by imposing specific obligations on certain corporate actors.

An interesting exception to the standard framework of federal 'corporate' laws, however, is the Employee Retirement Income Security Act of 1974 ("ERISA").¹⁰ ERISA's fiduciary standards govern the conduct of every fiduciary of every employer-sponsored employee benefit plan. Its unique approach focuses on the acts of individual corporate actors to define the scope of fiduciary obligation. Some corporate officers, as well as directors, typically become benefit plan fiduciaries.¹¹ Accordingly, ERISA attempts to

6. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002) (codified as amended in scattered sections of 11, 15, 18, 28, and 29 U.S.C.).

7. 15 U.S.C. §§ 77a–77aa (2000).

8. 15 U.S.C. §§ 78a–78mm (2000).

9. See, e.g., Robert B. Thompson & Hillary A. Sale, *Securities Fraud as Corporate Governance: Reflections upon Federalism*, 56 VAND. L. REV. 859, 861 (2003) ("[F]ederal law has increasingly occupied the space defining the duties and liabilities of officers.").

10. 29 U.S.C. §§ 1001–1461 (2000).

11. See *infra* notes 12–16 and accompanying text for a discussion of

correlate blameworthy behavior with personal liability while maintaining the flexibility that is a hallmark of fiduciary standards. As a result, ERISA is helpful in anticipating the issues that state corporate law will confront in its increasing focus on officer liability. Its approaches, and the continuing challenges it is experiencing in addressing those issues, also inform our discussion of the future complications expected in corporate law.

Our goals are to identify the issues expected to arise as a result of the growing state law emphasis on individual liability and to contribute to the future debate on how best to address those issues. We begin in Part II by considering the issues ERISA has confronted and its responses to those issues. Because it is based largely on a functional fiduciary analysis, ERISA's framework establishes liability based on the acts of individual fiduciaries. Unlike traditional trust law, which typically only needed to monitor a single or small number of trustees vis-à-vis a trust, the ERISA framework has developed to discipline the behavior of a varied number of fiduciaries for each benefit plan. Through its approach, ERISA attempts to constrain the behavior, particularly the opportunistic behavior, of corporate officers and others who make particular kinds of decisions that relate to benefit plans. This framework, while useful in linking liability and wrongdoing, requires consideration of which individual fiduciaries should be liable for wrongdoing, the role of expertise in setting fiduciary standards, the use of deferential standards in reviewing fiduciary decisions, and the evaluation of conflicts of interest.

In Part III, we begin by comparing the state corporate law fiduciary duties of officers with those of directors. After considering the genesis of fiduciary duty in corporate law, we next turn to contexts where courts have examined the specific obligations of directors. In Part IV, we draw together the ERISA and corporate law analysis to further consider the complications that corporate law will confront in correlating obligation with liability. We find that, unlike corporate law, ERISA has not distinguished among directors, officers, and other employees when evaluating alleged fiduciary obligation and responsibility. In contrast, both regimes are likely to continue to struggle with the role individual expertise should play in a duty of care analysis. When we consider the application of the business judgment rule to officer decisions, we find that ERISA has developed a number of context-specific deferential review standards. We also find that ERISA continues to struggle in its efforts to evaluate conflicts of interest and with how to adjust the review of fiduciary decisions to account for those conflicts. We anticipate that

corporate law will face similar difficulties in identifying and adjusting standards of fiduciary review for corporate officer conflicts of interest.

II. ERISA'S CORRELATION OF BEHAVIOR AND LIABILITY

This Part examines the challenges ERISA has faced in correlating individual responsibility and liability. We first describe how ERISA's definitions of who is a responsible fiduciary apply to corporate officers, executives, directors, and others who have responsibility for benefit plans. As we do in Part III for corporate law, we consider ERISA's reliance on trust law in its development of fiduciary standards. Finally, we explore three specific contexts where ERISA's fiduciary standards present analytical challenges in linking behavior and liability: the effect of expertise, the use of deferential review standards, and the impact of conflicts of interest.

A. *Fiduciary Duties of Officers and Directors*

The first challenge in correlating liability and wrongdoing is to ensure that the definition of which individuals have fiduciary responsibility is broad enough to sweep in all of the appropriate actors with benefit plan responsibility. If the definition of fiduciary sweeps too broadly, one would expect more difficulty in identifying which fiduciary has responsibility for a specific wrongful act. In comparison, a too narrow definition of fiduciary would let responsible individuals avoid responsibility.

The second challenge arises when one considers a specific instance of wrongdoing. An analytical framework is needed to identify which of the many fiduciaries has liability for the particular wrongdoing. A system that extends liability to fiduciaries who have no significant responsibility in the area of wrongdoing would be expected to increase costs without resulting in a concomitant decrease in wrongdoing. The opposite danger, though, is a system that would allow individual fiduciaries to avoid liability by arguing that the wrongful act occurred in another fiduciary's area of responsibility—perhaps with the result that, through such finger pointing, no fiduciary is held liable.

In its definition of who is a fiduciary, ERISA is democratic in its treatment of officers and directors. The statute does not distinguish between directors, officers, or other individuals in terms of whether they are fiduciaries or in the scope of their liability.¹² Nor have the

12. See H.R. REP. NO. 93-1280, at 323 (1974) (Conf. Rep.), as reprinted in 1974 U.S.C.A.N. 5038, 5103 ("Under this definition, fiduciaries include officers and directors of a plan, members of a plan's investment committee and persons who select these individuals.").

courts developed any jurisprudence treating officers differently from directors. Instead, the cases typically simply refer to the potential fiduciary liability or status of “officers and directors.”¹³ Unlike corporate law, there is no paucity of ERISA litigation alleging fiduciary breach by corporate actors below the rank of director. One explanation for the difference may be that, in contrast to corporate law, ERISA does not establish any demand requirement for suits alleging fiduciary breach.¹⁴

ERISA also diverges from corporate law in the sense that ERISA fiduciary status does not automatically inure on every officer and director.¹⁵ Instead, an officer or director, or any other individual or entity, may become a benefit plan fiduciary via two alternative routes.¹⁶ First, ERISA provides that a person’s actions may give rise to fiduciary status. Second, fiduciary status may be predicated on the formal terms of the benefit plan. The next sections explore those routes to fiduciary status.

1. *The Role of Actions Compared to Designation*

Under ERISA, a person becomes a fiduciary—regardless of title or formal appointment—to the extent she exercises discretion over plan management or assets, has discretionary authority over plan

13. *See, e.g.*, *Eaves v. Penn*, 587 F.2d 453, 458 (10th Cir. 1978) (“Similarly, officers and directors of the plan sponsor are fiduciaries if they exercise control through the selection of the investment committee, administrative committee, or plan officers or directors.”); *see also* EMPLOYEE BENEFITS COMM., EMPLOYEE BENEFITS LAW 633 (Steven J. Sacher et al. eds., 2d ed. 2000) (“Corporate officers and employees often engage in fiduciary activities in the course of their employment.”).

14. *See infra* note 132 and accompanying text (regarding the corporate law demand requirement).

15. *Gross v. Hale-Halsell Co.*, No. 04-CV-0098-CVE-FHM, 2006 WL 2666993, at *7 (N.D. Okla. Sept. 15, 2006) (“Even under the broad definition of ‘fiduciary’ . . . , an individual cannot be liable as an ERISA fiduciary solely by virtue of his position as a corporate officer or manager.”).

16. In addition, there is the possibility of liability for co-fiduciaries and even liability for nonfiduciaries who aid or participate in a fiduciary breach. ERISA makes specific provision for co-fiduciary liability. 29 U.S.C. § 1105(c)(1)-(2) (2000). It is less clear whether a nonfiduciary violates ERISA by participating in a fiduciary breach. *Compare* *Mertens v. Hewitt Assocs.*, 508 U.S. 248, 253-54 (1993) (“[W]hile ERISA contains various provisions that can be read as imposing obligations upon nonfiduciaries, including actuaries, no provision explicitly requires them to avoid participation (knowing or unknowing) in a fiduciary’s breach of fiduciary duty. It is unlikely, moreover, that this was an oversight, since ERISA *does* explicitly impose ‘knowing participation’ liability on cofiduciaries.” (citations omitted)), *with* *John Hancock Mut. Life Ins. Co. v. Harris Trust & Sav. Bank*, 510 U.S. 86, 106 (1993) (subjecting Hancock to fiduciary obligation due to a contract).

administration, or provides investment advice regarding plan assets in return for a fee.¹⁷ This focus on actions has come to be known as a functional way of defining fiduciary status and means that, unlike traditional trusts, benefit plans typically have far more than one or two trustees.¹⁸ The scope of each functional fiduciary's duties, however, is cabined by the principle that the officers and executives only act as plan fiduciaries when they are fulfilling plan fiduciary functions.

The result is that courts must determine who is a plan fiduciary by considering the role played by various corporate actors. For example, in *In re Electronic Data Systems Corp. ERISA Litigation*, the plaintiffs alleged that officers as well as the company, board members, and relevant plan committees assumed functions that caused them to become plan fiduciaries.¹⁹ The court read the plaintiffs' allegations as being sufficient to "allege that Defendants in fact selected and monitored the investment options [in the plan]."²⁰ The court determined that if the plaintiffs' allegations were accurate, then officers as well as directors became "functional fiduciaries by actually exercising authority and control respecting management of Plan assets."²¹

2. *The Role of Role*

The alternative route to becoming an ERISA fiduciary comes through formal designation, also known as named fiduciary status. In addition to the functional fiduciaries, ERISA requires each plan to establish at least one "named fiduciary."²² This formalized appointment parallels the designation of a fiduciary in a traditional trust.²³ When a benefit plan names an individual officer or executive as a fiduciary, the person's status as a plan fiduciary is clear.

Plans may designate individuals or entities, such as the corporation or a plan committee, as the named fiduciary.²⁴ If a plan fails to name a plan fiduciary, then the company that sponsors the

17. 29 U.S.C. § 1002(21)(A) (2000).

18. *Beddall v. State St. Bank & Trust Co.*, 137 F.3d 12, 18 (1st Cir. 1998) ("The key determinant of whether a person qualifies as a *functional fiduciary* is whether that person exercises discretionary authority in respect to, or meaningful control over, an ERISA plan, its administration, or its assets (such as by rendering investment advice)." (emphasis added)).

19. 305 F. Supp. 2d 658, 668 (E.D. Tex. 2004).

20. *Id.* at 666.

21. *Id.*

22. 29 U.S.C. § 1102(a).

23. *Id.* § 1103(a).

24. EMPLOYEE BENEFITS COMM., *supra* note 13, at 652.

plan is treated as the named fiduciary.²⁵ The default is consistent with practice because plans frequently designate the company as the named fiduciary.²⁶

3. *“Derivative” Fiduciary Status for Individuals Acting on Behalf of Entities: Derivative Approach vs. Entity Approach*

It would seem, given the very different mechanisms giving rise to named fiduciary status as compared to functional fiduciary status, that there would be little intersection between them. However, the question of how naming an entity as a fiduciary affects the functional fiduciary status of corporate officers and executives has important implications for ERISA’s ability to link individual fiduciary responsibility with potential liability for those corporate actors.

The determination of fiduciary status for officers and executives becomes interesting when a benefit plan document designates the company or some other entity, such as a plan investment committee, as the named fiduciary. Corporate law principles establish that directors are responsible for oversight and management of the company through the appointment of corporate officers.²⁷ So arguably, using the derivative approach, when the company is the named fiduciary, then all the directors necessarily become plan fiduciaries regardless of their actions and involvement with the plan because it is the directors who are ultimately charged with oversight and management of the company. Yet, holding directors responsible for all acts taken on behalf of a benefit plan would be inconsistent with ERISA’s attempt to correlate fiduciary responsibility reasonably closely with fiduciary actions. Accordingly, in many situations, directors are responsible for meeting their duty of care in the selection and oversight of lower level actors who, in turn, have fiduciary responsibility for their own acts.²⁸

Instead of directors, corporate officers and executives are likely,

25. 29 U.S.C. § 1002(16)(A)(ii).

26. Debra A. Davis, *Do-it-Yourself Retirement: Allowing Employees to Direct the Investment of Their Retirement Savings*, 8 U. PA. J. LAB. & EMP. L. 353, 376 (2006).

27. HARRY G. HENN & JOHN R. ALEXANDER, *LAW OF CORPORATIONS* § 207 (3d ed. 1983).

28. Kimberly Lynn Weiss, Note, *Directors’ Liability for Corporate Mismanagement of 401(K) Plans: Achieving the Goals of ERISA in Effectuating Retirement Security*, 38 IND. L. REV. 817, 835 (2005) (“Since ERISA recognizes that a person may be subject to fiduciary obligations for some purposes and not others, directors can be liable for failure to monitor and oversee plan committee members, even if they are not found liable with respect to the administrators’ investment decisions.”).

as plan committee members, to make the types of decisions—for example, on asset investment, availability of investment alternatives, and selection of plan vendors—that tend to give rise to significant numbers of claims of breach of the fiduciary duty of care. The issue then becomes whether designation of the entity, such as a plan committee, as a named fiduciary protects from personal liability the individuals who act on behalf of that entity. Under such an analysis, in what we refer to as the entity approach, the formal designation of an entity limits fiduciary liability for all of the actions taken on behalf of the entity to that entity. Alternatively, in what we will refer to as the derivative approach, it is necessary to identify the individuals responsible for the challenged action to the extent the actions would normally give rise to functional fiduciary status, and those individuals have potential personal liability.

The Third Circuit has accepted the entity approach, explaining:

When a corporation is the “person” who performs the fiduciary functions . . . the officer who controls the corporate action is not also the person who performs the fiduciary function. Because a corporation always exercises discretionary authority, control, or responsibility through its employees, [the statute] must be read to impute to the corporation some decisions by its employees. Otherwise, the fictional “person” of a corporation could never be a fiduciary because a corporation could never meet the statute’s requirement of “having discretion.” We cannot read [the statute] in a way that abrogates a use of corporate structure clearly permitted by ERISA.²⁹

Under the Third Circuit’s rationale, officers and executives only become fiduciaries if they explicitly accept individual discretionary roles over plan management, assets, or administration.³⁰ For example, when a corporation is the named fiduciary, it could formally delegate some portion of its fiduciary obligations to an officer or executive who accepts the delegation. That delegation would give rise to individual fiduciary status.³¹ But, in the absence of a delegation, actions taken by officers and executives on behalf of the named fiduciary would not result in the individuals assuming

29. *Confer v. Custom Eng’g Co.*, 952 F.2d 34, 37 (3d Cir. 1991).

30. *Id.* The court actually refers only to discretion over plan administration as giving rise to fiduciary status. *Id.* That language is understandable given the context of the case, but, given the relevant statutory language on functional fiduciary status, the court’s reasoning would seem to extend to discretionary functions that relate to plan management or assets. It also would seem to apply to investment advice provided for a fee, though that is rarely within the scope of duties of a corporate director or officer.

31. *Id.*

any fiduciary obligations.

Other courts that have examined this issue have disagreed with the Third Circuit and follow the derivative approach.³² For example, the Ninth Circuit reasoned that ERISA separately defines “fiduciary” and “named fiduciary” and does not contain an exemption from fiduciary status for functional actors who perform duties as agents of a named fiduciary.³³ Further, the statute forbids relieving any fiduciary from liability except through insurance.³⁴ The Ninth Circuit viewed a benefit plan’s provision, which stated that directors and officers did not act “as individual fiduciaries,” as a prohibited attempt to relieve fiduciaries from liability.³⁵ Finally, the court buttressed its decision with Department of Labor regulations recognizing that fiduciary status may be based on functional activities.³⁶ In a later case, the Ninth Circuit extended its rationale to a situation where a benefit plan designated a committee instead of the company as the named fiduciary.³⁷ According to the court, “where, as here, a committee or entity is named as the plan fiduciary, the corporate officers or trustees who carry out the fiduciary functions are themselves fiduciaries and cannot be shielded from liability by the company.”³⁸

The resolution of this debate has important implications for the correlation of possible personal liability with individual responsibility. The Third Circuit’s entity approach, though grounded in the statutory language, permits plan sponsors to designate committees or companies as responsible actors. The result is that individual officers and directors who actually undertake the types of discretionary actions that the statute defines as giving rise to fiduciary responsibility avoid the personal liability that ERISA established to protect plan participants and beneficiaries.

The resulting break in the link between responsibility for decision making and liability has an even more perverse implication when corporate officers and executives simply fail to exercise their discretionary powers as plan committee members. Arguably, since

32. *See* *Kayes v. Pac. Lumber Co.*, 51 F.3d 1449, 1461 (9th Cir. 1995) (holding that an officer of a named plan fiduciary was liable as a fiduciary); *see also* *Bannistor v. Ullman*, 287 F.3d 394, 405–07 (5th Cir. 2002) (determining that corporate officers were liable as fiduciaries).

33. *Kayes*, 51 F.3d at 1460.

34. 29 U.S.C. § 1110 (2000).

35. *Kayes*, 51 F.3d at 1459–60.

36. *Id.* at 1460–61.

37. *Stewart v. Thorpe Holding Co. Profit Sharing Plan*, 207 F.3d 1143, 1156–57 (9th Cir. 2000).

38. *Id.* at 1156.

the corporate actors have not exercised any of the discretionary powers that give rise to fiduciary status, they will not incur any liability even though their failure to take action results in harm to the plan's participants and beneficiaries.

B. Linking Fiduciary Wrongdoing and Liability

Setting aside for the moment the appointment of entities as fiduciaries, by using both the functional and formal appointment routes to define who is a fiduciary, ERISA effectively sweeps in all individuals with discretion over benefit plans. The power of that broad definitional net creates the need for a second level of analysis. Once a wrongful act occurs, it becomes necessary to identify which of the many fiduciaries is responsible for that wrongful act.

ERISA's approach is to cabin each individual fiduciary's obligation and potential liability to those specific discretionary functions assumed by that individual.³⁹ The link is between the acts that gave rise to fiduciary status and the acts for which that fiduciary has potential liability. Agency concepts would imply that this approach based in discretion would vest greater fiduciary responsibility with individuals who hold positions higher up the corporate structure because, in a corporation, the scope of discretion typically correlates with position level within the corporate hierarchy. But ERISA's use of discretion is quite different and not based on hierarchy. Rather, it concentrates on the actual discretion to take action with respect to plan assets or administration. If the actual exercise of such discretion is not part of an individual's responsibilities, then the individual does not have direct fiduciary responsibility or liability for the discretionary act.

Interestingly, this approach protects from responsibility and liability both lower-level employees and higher-level executives, officers, and directors. Plan fiduciaries who hold corporate positions above that of the fiduciary who has discretionary responsibility typically have only the fiduciary responsibility to properly appoint and oversee the fiduciary who has discretion.⁴⁰ Take as a simple example the board of directors. Board members typically will be responsible for exercising due care in the appointment and oversight of plan fiduciaries. But, board members do not have direct fiduciary responsibility for decisions made by, as an example, the individual charged with making discretionary interpretations regarding benefit eligibility.

How tightly the fiduciary provisions are able to correlate blameworthy behavior of corporate officers and other actors with

39. 29 U.S.C. § 1002(21)(A) (2000).

40. 29 U.S.C. § 1105.

personal liability for those individuals depends on whether a derivative or entity approach is used. The entity approach to fiduciary obligation permits corporations to break the link between blameworthy individual decision making and personal responsibility simply by appointing entities, such as plan committees, as the formal decision makers. Conversely, the derivative approach more closely aligns with the statute's attempt to designate individuals as fiduciaries based on their actions and to impose personal liability for breach of fiduciary obligations.

The obligations of ERISA fiduciaries were originally derived from trust law. Although ERISA applies to the full spectrum of employer-sponsored benefit plans, Congress' focus on the regulation of pension plans is even reflected in ERISA's title—the Employee Retirement Income Security Act.⁴¹ It is hardly surprising then, given the use of trusts as pension vehicles prior to ERISA, that the regulation requires almost all plan assets to be held in trust.⁴² Patterning ERISA's fiduciary standards after those established under trust law seems to have followed naturally from the traditional use and regulation of pension trusts.

Fiduciary status is relevant primarily to the extent that the status imposes constraints on the fiduciary. In addition to paralleling corporate law in its derivation of fiduciary standards from trust law, two of the duties that ERISA establishes parallel the duties of loyalty and care found in corporate law. ERISA's version of the duty of loyalty requires fiduciaries to act “for the exclusive purpose of: (i) providing benefits to participants and their beneficiaries; and (ii) defraying reasonable expenses of administering the plan.”⁴³ In order to comply with the duty of care, an ERISA fiduciary must act in accordance “with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims.”⁴⁴ In addition, ERISA requires fiduciaries to diversify the investments of some benefit plans and to act in accordance with plan documents to the extent the documents comply with ERISA.⁴⁵

Although Congress patterned ERISA's fiduciary provisions on

41. 29 U.S.C. §§ 1001–1461.

42. 29 U.S.C. § 1103(a).

43. 29 U.S.C. § 1104(a)(1)(A). For a critique of this provision, see generally Daniel R. Fischel and John H. Langbein, *ERISA's Fundamental Contradiction: The Exclusive Benefit Rule*, 55 U. CHI. L. REV. 1105, 1108–10 (1988).

44. 29 U.S.C. § 1104(a)(1)(B).

45. 29 U.S.C. § 1104(a)(1)(C)–(D).

traditional trust law, it made clear that the standards should be construed “with modifications appropriate for employee benefit plans.”⁴⁶ Specific ERISA deviations, such as the determination of fiduciary status, tailor fiduciary obligation to the complexities of employee benefit plans.⁴⁷ This tailoring is in contrast to corporate fiduciary law, which has relied primarily on a common law approach that hews more closely to traditional trust and agency law.

The next Section examines ERISA’s fiduciary standards in three contexts. First, it considers the role of expertise in establishing the duty of care. Second, it evaluates ERISA’s use of deferential standards that insulate some fiduciary decision making. Third, it considers the effect of the conflicts of interest that often are inherent in ERISA fiduciary status.

C. Relevance of Expertise, Use of Deferential Standards, and Conflicts of Interest

1. Considerations of Expertise

The concentration of fiduciary responsibility in the individuals charged with discretionary decision making raises the issue of the extent to which the expertise of a particular individual should affect the standard applied in a due care analysis. This issue, of course, has a direct corollary in corporate law. Although it has only recently surfaced in corporate law, it is not a new controversy in the ERISA context.

Commentators⁴⁸ and courts⁴⁹ are divided on whether ERISA’s

46. *Donovan v. Cunningham*, 716 F.2d 1455, 1464 (5th Cir. 1983).

47. *See supra* notes 12–21 and accompanying text.

48. *Compare* Bernard Black et al., *Outside Director Liability*, 58 STAN. L. REV. 1055, 1137 (2006) (stating that the ERISA standard is “often called a ‘prudent expert’ standard”), and Mark J. Roe, *The Modern Corporation and Private Pensions*, 41 UCLA L. REV. 75, 102 (1993) (referring to “ERISA’s prudent expert rule”), with EMPLOYEE BENEFITS COMM., *supra* note 13, at 666 (“Prudence is measured according to the objective ‘prudent man’ standard”). *See also* David Hess, *Protecting and Politicizing Public Pension Fund Assets: Empirical Evidence on the Effects of Governance Structures and Practices*, 39 U.C. DAVIS L. REV. 187, 219 (2005) (suggesting that the appropriate focus is on “ensur[ing] that a board of trustees has the expertise to perform its duties”).

49. *Compare In re Bicoastal Corp.*, 191 B.R. 238, 243 (Bankr. M.D. Fla. 1995) (explaining that the statutory section “explicitly holds fiduciaries to the standard of a prudent expert, rather than that of a prudent layman”), and *Howard v. Shay*, No. CV 91-146 DT, 1993 U.S. Dist. LEXIS 20153, at *37 (C.D. Cal. Sept. 15, 1993) (“The standard is generally understood as that of a prudent expert.”), with *Cunningham*, 716 F.2d at 1467 n.26 (deciding that a review of the provision’s history does not support the prudent expert standard), and

prudence standard is that of a prudent person or a prudent expert. The ambiguity begins in the statutory language. The reference to a “prudent man” requirement arguably sets the standard as that of a prudent person. Next, though, the language refers to the prudent man as “acting in a like capacity and familiar with such matters,”⁵⁰ which some interpret to establish a prudent expert standard.⁵¹

The controversy in the case law is traceable to *Donovan v. Cunningham*, a case dealing with alleged fiduciary breach in the context of the pricing of securities in an Employee Stock Ownership Plan (“ESOP”).⁵² The Fifth Circuit recognized that commentators had suggested that ERISA’s language calls for a prudent expert standard.⁵³ The court, however, stated that “a review of the relevant history of [the provision] does not support this view.”⁵⁴ At the same time, the Fifth Circuit noted that the duty of care standard is flexible and stated both that “[t]he level of knowledge required of a fiduciary will vary with the nature of the plan”⁵⁵ and that “the adequacy of a fiduciary’s investigation is to be evaluated in light of the ‘character and aims’ of the particular type of plan he serves.”⁵⁶

One court, like the court in *Cunningham*, explicitly rejected the use of a “prudent expert” standard, but, at the same time, established some flexibility in the standard. In *Harley v. Minnesota Mining & Manufacturing Co.*, the district court addressed claims that the defendant, 3M, breached its fiduciary duty by permitting company employees to invest defined benefit plan assets in a risky hedge fund.⁵⁷ Allegedly, those investments depleted defined benefit plan assets by \$80 million.⁵⁸ According to the court, “ERISA does not impose a rule that fiduciaries be ‘experts’ on all types of investments they make.”⁵⁹

In spite of rejecting the expert standard of care, the *Harley* court’s analysis set a flexible and relatively high standard of care. First, it opined that fiduciaries without the expertise to properly

Thompson v. Avondale Indus. Inc., No. Civ. A. 99-3439, 2003 WL 359932, at *13 (E.D. La. Feb. 14, 2003) (“The reference in ERISA . . . to a prudent man ‘familiar with such matters’ does not create a ‘prudent expert’ . . .”).

50. 29 U.S.C. § 1104(a)(1)(B) (2000).

51. See *supra* note 48.

52. *Donovan v. Cunningham*, 716 F.2d 1455, 1458 (5th Cir. 1983).

53. *Id.* at 1467 n.26.

54. *Id.*

55. *Id.*

56. *Id.* at 1467.

57. 42 F. Supp. 2d 898, 900–04 (D. Minn. 1999), *aff’d on other grounds*, 284 F.3d 901 (8th Cir. 2002) (finding no cognizable damage to the plan).

58. *Harley*, 42 F. Supp. 2d at 904.

59. *Id.* at 907.

evaluate investment options must hire independent advisors.⁶⁰ The company had argued that it hired the hedge fund, which had recommended the investments, in order to obtain investment expertise, and that it should not be required to hire another expert to oversee the expertise of the hedge fund.⁶¹ According to the court, however, 3M had a continuing obligation to oversee and monitor the hedge fund.⁶² Since 3M did not have the internal expertise to perform that oversight, 3M should have sought outside assistance in order to fulfill its duty of care.⁶³ The court rejected 3M's summary judgment request on the basis that the company's oversight could reasonably be found to be below the applicable standard of care.⁶⁴

Two courts have explicitly adopted a prudent expert standard under ERISA. *Howard v. Shay* arose out of an ESOP's sale of securities of a privately held company to a trust established in favor of the son of the company's primary owner.⁶⁵ The plaintiffs, all of whom were employees of the company and participants in the ESOP, alleged that the securities were sold for less than fair market value.⁶⁶ They brought suit for breach of ERISA's fiduciary obligations against company officers as well as directors.⁶⁷ The court did not distinguish in any way between the fiduciary obligations of the directors and those of the officers. However, it did decide that, while the duty of care is primarily procedural, the applicable standard is "that of a prudent expert."⁶⁸ The court went on to state that the duty of care "may also require a fiduciary to obtain expert advice."⁶⁹ The ESOP committee had relied on an independent valuation and fairness opinion by Arthur Young & Company to set the price of the securities.⁷⁰

The most recent decision to address the role of expertise in an ERISA plan is *Thompson v. Avondale Industries, Inc.*⁷¹ In

60. *Id.*

61. *Id.*

62. *Id.* at 907-08.

63. *Id.* at 908.

64. *Id.* at 909.

65. No. CV 91-146 DT, 1993 U.S. Dist. LEXIS 20153, at *2-3 (C.D. Cal. Sept. 15, 1993).

66. *Id.*

67. *Id.*

68. *Id.* at *37.

69. *Id.*

70. *Id.* at *11-19; see also *In re Bicoastal Corp.*, 191 B.R. 238, 243 (Bankr. M.D. Fla. 1995) ("[ERISA's duty of care provision] explicitly holds fiduciaries to the standard of a prudent expert, rather than that of a prudent layman. In situations where Pension Plan fiduciaries are making loans, the fiduciary is held to the standard of professional bankers and bank investment advisers.").

71. No. Civ. A. 99-3439, 2003 WL 359932, at *22 (E.D. La. Feb. 14, 2003)

Thompson, the court cited *Cunningham* in deciding that “[t]he reference in ERISA . . . to a prudent man ‘familiar with such matters’ does not create a ‘prudent expert’ under ERISA, and prudent fiduciaries are entitled to rely on the advice they obtain from independent experts.”⁷² As in *Howard*, the plaintiffs in *Thompson* were employee participants in an ESOP.⁷³ The employees alleged that plan fiduciaries breached their obligations by causing the ESOP to reduce its holdings of employer stock in order to reduce the power of the employees and the union.⁷⁴ The fiduciary defendants consisted of members of the company’s ESOP committee, as well as executive officers who also served as company directors.⁷⁵ The court found that the ESOP committee members met their duty of care in selling company securities held by the ESOP.⁷⁶ The management defendants similarly met their duty of care by choosing committee members who were long-time company employees from varied areas of the workforce.⁷⁷

In sum, the courts and commentators are divided on whether ERISA’s duty of care establishes a prudent expert standard. At a minimum, though, the standard typically applied is a flexible standard that takes into account the nature of the benefit plan at issue and, if the claim deals with investment of plan assets, the level of sophistication of the investments. There is no evidence that courts have taken into account the expertise of plan fiduciaries and held fiduciaries with greater expertise to a higher level of care as did the Delaware Chancery Court in its decision in *In re Emerging Communications, Inc. Shareholder Litigation*.⁷⁸

2. Use of Deferential Standards Favoring Corporate Officers

Corporate law commentators have taken opposing positions on whether officers should be entitled to the protection of the business judgment rule.⁷⁹ In contrast, as with the determination of fiduciary status and application of fiduciary standards, the ERISA jurisprudence does not draw any distinction in the application of

(holding that the preponderance of the evidence did not show that the plan fiduciaries breached their duty of care or loyalty).

72. *Id.* at *13.

73. *Id.* at *1.

74. *Id.* at *2–3.

75. *Id.* at *1–3.

76. *Id.* at *22.

77. *Id.* at *18.

78. No. 16415, 2004 Del. Ch. LEXIS 70, at *137–40 (Del. Ch. June 4, 2004). See *infra* notes 193–207 and accompanying text for a discussion of *In re Emerging Commc’ns*.

79. See *infra* notes 166–191 and accompanying text.

ERISA's deferential standards based on whether the individual fiduciaries are directors, officers, or other actors. As discussed in the next subsection, though, there are substantial questions about, and criticism of, the scope of ERISA's deferential standards, based primarily on considerations of conflicts of interest. This subsection considers the derivation of two deferential standards used to review fiduciary decisions.

The business judgment rule itself has no application in the ERISA context. One district court in an ERISA case explained its decision in favor of the defendants by stating: "[u]tilizing the 'business judgment' rule, this Court cannot find that the PAE ESOP committee breached any fiduciary duty in relying on the Arthur Young & Company . . . valuation."⁸⁰ On appeal, the Ninth Circuit reversed the district court judgment, finding that the business judgment rule has no relevance in evaluating whether an ERISA fiduciary has met the standards of care and loyalty.⁸¹

While rejecting the applicability of the business judgment rule, the ERISA jurisprudence has developed deferential reviews for specific decisions of ERISA fiduciaries. For example, the Third Circuit developed a presumption that ESOP fiduciaries who decide to invest ESOP assets in employer stock have met their duty of care.⁸² Plaintiffs may overcome the presumption by showing the investment decision constituted an abuse of discretion.⁸³ The Third Circuit suggested that "circumstances not known to the settlor and not anticipated by him . . . [that] would defeat or substantially impair the accomplishment of the purposes of the trust" could be sufficient to rebut the presumption.⁸⁴

The Third Circuit derived the ESOP investment presumption and abuse of discretion standard from ERISA's statutory language, which favors the use of ESOPs, as well as the statute's basis in the law of trusts.⁸⁵ The court also looked back at the Supreme Court's foundational 1989 decision in *Firestone Tire & Rubber Co. v. Bruch*.⁸⁶ Although explicitly limited to fiduciary determinations of benefit eligibility, the Supreme Court in *Firestone* relied heavily on trust law to adopt an abuse of discretion standard of review when a

80. *Howard v. Shay*, No. CV 91-146 DT, 1993 U.S. Dist. LEXIS 20153, at *40 (C.D. Cal. 1993).

81. *Howard v. Shay*, 100 F.3d 1484, 1489 (9th Cir. 1996) ("The business judgment rule is a creature of corporate, not trust, law.").

82. *Moench v. Robertson*, 62 F.3d 553, 571 (3d Cir. 1995).

83. *Id.*

84. *Id.* (citing RESTATEMENT (SECOND) OF TRUSTS § 227(a) cmt. g (1959)).

85. *Id.* at 568-70.

86. *Firestone Tire & Rubber Co. v. Bruch*, 489 U.S. 101 (1989).

benefit plan grants interpretative discretion to a plan fiduciary.⁸⁷

Some courts have considered extending the presumption in favor of ESOP investments in employer stock to the 401(k) context.⁸⁸ Commentators, including the authors, have expressed wariness about broader application of the ESOP presumption because such expansion is not supported by the statutory language governing the pension savings goals of 401(k) plans.⁸⁹ It appears to be accepted without question, though, that in whatever contexts the presumption applies, it applies to all fiduciaries charged with the relevant decision making, regardless of their status as directors, officers, or even outsiders of the employer that sponsors the plan. Similarly, in the context of determinations of benefit eligibility, criticism of the abuse of discretion standard is typically grounded in the conflicts of interest of fiduciaries relying on that standard. Otherwise, the fiduciary's position vis-à-vis the sponsoring employer and the benefit plan is irrelevant.

Perhaps the most widely applied deferential standard in ERISA is the standard that is used to evaluate decisions on benefit eligibility. In *Firestone Tire & Rubber Co. v. Bruch*, the Supreme Court approved the use of a deferential standard to review benefit eligibility decisions when a benefit plan grants interpretative discretion to the appropriate plan fiduciary.⁹⁰ The Court distinguished between situations where the terms of a trust grant interpretative discretion to the plan trustee, in which case a deferential standard of review is appropriate,⁹¹ and plans such as the termination plan at issue in *Firestone*. When a plan, like *Firestone's*, does not contain a delegation of discretion, then eligibility decisions are to be reviewed using a de novo standard.⁹²

Looking only at this portion of the *Firestone* decision, it appears that plan sponsors may attain a deferential standard of review for benefit decisions by including language in the plan that reserves deference to the plan administrator. When a benefit plan contains

87. *Id.* at 111.

88. *See, e.g., In re WorldCom, Inc.*, 263 F. Supp. 2d 745, 764–65 (S.D.N.Y. 2003) (citing *Moench v. Robertson*, 62 F.3d 553, 571–72 (3d Cir. 1995)).

89. *See, e.g., Dana M. Muir & Cindy A. Schipani, New Standards of Director Loyalty and Care in the Post-Enron Era: Are Some Shareholders More Equal Than Others?*, 8 N.Y.U. J. LEGIS. & PUB. POL'Y 279, 334 (2005) (“The absence of a statutory requirement that 401(k) plan assets be invested primarily in employer stock and the potential for conflicts of interest may militate for a more stringent level of scrutiny of fiduciary compliance with ERISA’s prudence standards in those cases.”).

90. *Firestone*, 489 U.S. at 111.

91. *Id.*

92. *Id.* at 112.

such a grant of discretion, the standard of review applied is stated as either arbitrary and capricious or abuse of discretion.⁹³ *Firestone* is not quite that simple though. The Supreme Court recognized that fiduciary conflicts of interest should affect the standard of review, stating that: "if a benefit plan gives discretion to an administrator or fiduciary who is operating under a conflict of interest, that conflict must be weighed as a 'facto[r] in determining whether there is an abuse of discretion.'"⁹⁴ The circuit courts have struggled since *Firestone* to articulate standards of review that properly account for the existence of conflicts.⁹⁵ The next Subsection turns to the serious difficulties courts have confronted in dealing with conflicts of interest by ERISA fiduciaries.

3. *The Impact of Conflicts of Interest*

One of the most intractable problems ERISA has confronted has been how to adjust fiduciary standards, including the deferential review standards, for conflicts of interest. The problem is inherent in ERISA because the statute builds in a structural conflict of interest by explicitly allowing agents of plan sponsors to act as ERISA fiduciaries.⁹⁶ The departure from traditional trust law is rationalized by the argument that benefit plan sponsorship is voluntary and employers would be unduly discouraged from sponsoring plans if they were not permitted to designate their own agents as plan fiduciaries.⁹⁷ This very rationalization, however, implicitly recognizes that those employer agents may be tempted to act contrary to the interests of the employees who rely on the benefit plan.

The problem of conflicts of interest has challenged the courts, particularly in the context of deferential review standards. In establishing the ESOP investment presumption, the Third Circuit recognized the relationship between conflicts of interest and the duty of care. The fiduciaries of a company struggling with financial difficulties will often be subject to competing interests.⁹⁸ As a result, according to the court, "the more uncertain the loyalties of the fiduciary, the less discretion it has to act."⁹⁹

As discussed above, in *Firestone*, the Supreme Court recognized

93. Mark D. DeBofsky, *What Process is Due in the Adjudication of ERISA Claims?*, 40 J. MARSHALL L. REV. (forthcoming Spring 2007).

94. *Firestone*, 489 U.S. at 115 (quoting RESTATEMENT (SECOND) OF TRUSTS § 187 cmt. d (1959)).

95. DeBofsky, *supra* note 93.

96. 29 U.S.C. § 1108(c)(3) (2000).

97. See Fischel & Langbein, *supra* note 43, at 1126-28.

98. *Moench v. Robertson*, 62 F.3d 553, 572 (3d Cir. 1995).

99. *Id.*

that fiduciary conflicts of interest should affect the standard of review and suggested weighing the conflict as a factor.¹⁰⁰ The lower courts' application of *Firestone's* abuse of discretion standard in reviewing benefit determinations has garnered significant criticism from commentators, particularly when the fiduciary is operating under a conflict of interest.¹⁰¹ Of particular interest for purposes of this Article is the circuits' struggle to determine whether an insurer, operating as a fiduciary decision maker, acts under a sufficient conflict of interest to require application of other than the arbitrary and capricious standard of review, and, if so, what the standard should be. Most circuits at least indicate concern with conflicts in this context.¹⁰² The Seventh Circuit, though, has rejected arguments that such conflicts should give rise to increased scrutiny of fiduciary decision making.¹⁰³

III. CORPORATE LAW

Corporate law is more settled than ERISA jurisprudence in establishing that corporate officers are fiduciaries. Yet, although corporate law jurisprudence significantly predates the enactment of ERISA,¹⁰⁴ corporate case law relating to the standards of fiduciary analysis for corporate officers seems rather undeveloped when compared to the ERISA case law. Courts considering these issues might find the ERISA courts' analyses, focusing on the obligations of fiduciaries, instructive.

There is, however, precedent in corporate law for a broader contextual approach that may help correlate obligation with liability. For example, the Delaware Chancery Court considered the

100. *Firestone Tire & Rubber Co. v. Bruch*, 489 U.S. 101, 115 (1988) (quoting RESTATEMENT (SECOND) OF TRUSTS § 187, cmt. d (1959)).

101. See, e.g., Mark D. DeBofsky, *The Paradox of the Misuse of Administrative Law in ERISA Benefit Claims*, 37 J. MARSHALL L. REV. 727, 733 (2004) ("Whatever hope existed that the courts would regain their bearings and exclude administrative law concepts from ERISA claims was demolished by the Supreme Court in its watershed ruling in *Firestone* . . ."); Kathryn J. Kennedy, *Judicial Standard of Review in ERISA Benefit Claim Cases*, 50 AM. U. L. REV. 1083, 1119 (2001) ("The purpose of this article is to critique the courts' applications of the *de novo* and the abuse of discretion standards of review, particularly in the context of certain conflict of interest situations."); John H. Langbein, *The Supreme Court Flunks Trusts*, 1990 SUP. CT. REV. 207, 207-08 (1990).

102. DeBofsky, *supra* note 93.

103. *Id.*

104. ERISA was enacted in 1974. In comparison, limited liability statutes for manufacturing companies were adopted in New Hampshire, Connecticut, Maine, and Massachusetts from 1816 to 1830. Phillip I. Blumberg, *Limited Liability and Corporate Groups*, 11 J. CORP. L. 573, 593 (1986).

background and experience of one of the outside directors on the board of Emerging Communications, Inc., in deciding that he breached his fiduciary duty to the minority shareholders.¹⁰⁵ The court distinguished this director's obligation, and therefore liability, from that of the other members of the board. Similarly, although there are relatively few cases in which directors have been found liable for due care violations, some of the early cases finding liability involved the special obligations of directors of financial institutions.¹⁰⁶ In these cases, the courts emphasized the role that directors of financial institutions play in upholding the public trust.

Although not directly addressing a liability issue, it is also noteworthy that recently the Delaware Chancery Court found it necessary to consider the relationships of directors with each other to address the issue of their independence. These cases arose in the context of judicial determination of whether the directors serving on a special litigation committee met the threshold of independence—enabling them to exercise impartiality when determining whether the shareholder derivative litigation should proceed.¹⁰⁷ The Chancery Court examined the extent to which these relationships could potentially compromise the directors' ability to render impartial decisions.

These cases seem to evidence flexibility in corporate law to consider the context in which fiduciary obligations arise and the potential to correlate liability for breach with that obligation. As demonstrated in Part II, there is ample precedent in the ERISA jurisprudence from which corporate law might draw to further this objective.

We begin this Part with a discussion of the fiduciary duties of officers and directors in Section A. In Section B, we consider the genesis of corporate law fiduciary duties and the role of the law of trusts and agency to the extent they are relevant to our analysis. Section C explores the current debate in the corporate law arena regarding whether officers should be afforded the presumption that their decisions were made in good faith and in the best interest of the corporation, i.e., whether their decisions should be protected by the deferential business judgment rule. In Section D, we discuss

105. *In re Emerging Commc'ns. Inc., S'holders Litig.*, No. Civ. A. 16415, 2004 WL 1305745, at *39-40 (Del. Ch. 2004). See *infra* notes 195-208 and accompanying text for further discussion of this case.

106. Cindy A. Schipani, *Should Bank Directors Fear FIRREA: The FDIC's Enforcement of the Financial Institutions Reform, Recovery and Enforcement Act*, 17 J. CORP. L. 739, 748-51 (1992). See *infra* notes 208-224 and accompanying text for a discussion of this issue.

107. See *infra* notes 223-35 and accompanying text for a discussion of this issue.

three corporate law contexts, identified above, where courts have considered specific contexts relevant to the duties and obligations of directors. We conclude that it is likely that such a contextual approach may be applied by future courts attempting to correlate the obligations of officers with liability.

A. *Fiduciary Duties of Officers and Directors*

It is well settled that officers and directors are fiduciaries under Delaware law.¹⁰⁸ The two primary fiduciary obligations are the duty of loyalty and the duty to act with due care.¹⁰⁹ The duty of loyalty requires that corporate interests supersede personal interests, and when conflicts of interest occur, they must either be avoided or disclosed and approved by disinterested directors.¹¹⁰ In addition to the duties of care and loyalty, corporate actors are faced with a duty to act in good faith, though, the Delaware Supreme Court has recently opined that the duty to act in good faith is part of the duty of loyalty and that lacking good faith alone will not trigger liability.¹¹¹

The duty of care requires corporate actors to perform their duties with the reasonable care of a prudent person acting under

108. Aaron D. Jones, *Corporate Officer Wrongdoing and the Fiduciary Duties of Corporate Officers Under Delaware Law*, 44 AM. BUS. L.J. 475, 476 (2007) (“State corporate law is clear that officers are fiduciaries, but that is about all that is clear regarding the state law obligations of corporate officers.”).

109. See *infra* notes 110–113 and accompanying text.

110. For a more in-depth consideration of the duty of loyalty, see generally Dana M. Muir & Cindy A. Schipani, *The Challenge of Company Stock Transactions for Directors’ Duties of Loyalty*, 43 HARV. J. ON LEGIS., 437, 444–57 (2006). Moreover, a majority of jurisdictions have codified the duty of loyalty. See ALA. CODE § 10-2B-8.30 (2006); ALASKA STAT. § 10.06.450 (2006); ARIZ. REV. STAT. ANN. § 10-830 (2004); CAL. CORP. CODE § 309 (Deering 2003); CONN. GEN. STAT. ANN. § 33-756 (2005); FLA. STAT. ANN. § 607.0830 (West 2001); GA. CODE ANN. § 14-2-830 (2003); HAW. REV. STAT. § 414-221 (2004); IOWA CODE ANN. § 490.830 (West 1999 & Supp. 2007); KY. REV. STAT. ANN. § 271B.8-300 (LexisNexis 2003); ME. REV. STAT. ANN. tit. 13-C, § 831 (2005); MD. CODE ANN., CORPS. & ASS’NS § 2-405.1 (LexisNexis 1999); MASS. ANN. LAWS ch. 156B, § 65 (LexisNexis 2005); MICH. COMP. LAWS SERV. § 450.1541a (LexisNexis 2006); MINN. STAT. ANN. § 302A.251 (West 2004 & Supp. 2007); MISS. CODE ANN. § 79-4-8.42 (2001); MONT. CODE ANN. § 35-2-441 (2005); N.H. REV. STAT. ANN. § 293-A:8.30 (LexisNexis 2001); N.M. STAT. ANN. § 53-4-18.1 (LexisNexis 2004); N.C. GEN. STAT. § 55-8-30 (2005); N.D. CENT. CODE § 10-19.1-50 (2005); OHIO REV. CODE ANN. § 1701.59 (LexisNexis 2004); OR. REV. STAT. § 60.357 (2005); 15 PA. CONS. STAT. ANN. § 1712 (West 1995); S.C. CODE ANN. § 33-8-300 (2006); TENN. CODE ANN. § 48-18-301 (2002); VA. CODE ANN. § 13.1-690 (2006); WASH. REV. CODE ANN. § 23B.08.300 (West 1994); W. VA. CODE ANN. § 31D-8-830 (LexisNexis 2003); WYO. STAT. ANN. § 17-16-830 (2005).

111. *Stone v. Ritter*, 911 A.2d 362, 369–70 (Del. 2006).

similar circumstances.¹¹² In addition, the duty of care, at least as it has been applied to directors, requires that directors be adequately informed.¹¹³

As will be discussed below, Delaware law further modifies the duty of care by applying the business judgment rule with the result that liability emerges only in the case of gross negligence.¹¹⁴ This was the holding of the Delaware Supreme Court in *Smith v. Van Gorkom*, where directors were held grossly negligent in the process they employed in approving a merger.¹¹⁵ The *Van Gorkom* court found that the directors failed to obtain all reasonably available information regarding the true intrinsic value of the corporation before recommending that the shareholders accept the proposed tender offer.¹¹⁶ This failure in process supported a finding of gross negligence.¹¹⁷

In addition, directors may be exculpated for grossly negligent conduct if such a provision is included in the company's articles of incorporation.¹¹⁸ Approximately eighteen months after the decision in *Smith v. Van Gorkom*, the Delaware legislature promulgated Section 102(b)(7) of the Delaware Code to permit corporations to further limit or even eliminate monetary liability for due care violations of directors vis-à-vis the corporation and its shareholders.¹¹⁹ Thus, even though the standard of care is one of

112. See *infra* note 142 and accompanying text; see also Carter G. Bishop, *A Good Faith Revival of Duty of Care Liability in Business Organization Law*, 41 TULSA L. REV. (forthcoming) (manuscript at 485, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=930402).

113. See *Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del. 1985) (holding that the board of directors violated the duty of care they owed the corporation by not being properly informed).

114. *Id.* at 873.

115. *Id.* at 881.

116. *Id.* at 874.

117. *Id.* at 874-81.

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

119. *Id.* This statute permits Delaware corporations to include the provision in their articles of incorporation:

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) For 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; 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

gross negligence, there is no monetary liability attached to its violation in shareholder suits, provided that there is no evidence of breach of the duty of loyalty, intentional misconduct, or lack of good faith.¹²⁰ Perhaps even more noteworthy is that Section 102(b)(7) is not available to exculpate negligent conduct of officers.¹²¹

The Delaware Supreme Court recently had occasion to consider whether directors breached their duty of care in *In re Walt Disney Co. Derivative Litigation*.¹²² One of the allegations made against the

paragraph to a director shall also be deemed to refer (x) to a member of the governing body of a corporation which is not authorized to issue capital stock, and (y) 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, exercise or perform any of the powers or duties otherwise conferred or imposed upon the board of directors by this title.

Id. The following statutes are similar: ALA. CODE. § 10-2B-2.02(3) (2006); ALASKA STAT. § 10.06.210(1)(N) (2006); ARIZ. REV. STAT. ANN. § 10-202(B) (2004); ARK. CODE ANN. § 4-27-202(b)(3) (2001); CAL. CORP. CODE § 204(a)(10) (Deering 2003); GA. CODE ANN. § 14-2-202(b)(4) (2003); IDAHO CODE ANN. § 30-1-202(2)(d) (2005); 805 ILL. COMP. STAT. ANN. 5/2.10(b)(3) (West 2004); IOWA CODE ANN. § 490.832 (West 1999 & Supp. 2007); KAN. STAT. ANN. § 17-6002(b)(8) (1995); KY. REV. STAT. ANN. § 271B.2-020(2)(d) (LexisNexis 2003); LA. REV. STAT. ANN. § 12:24(c)(4) (1994); MASS. ANN. LAWS ch. 156B, § 13(b)(1 ½) (LexisNexis 2005); MICH. COMP. LAWS SERV. § 450.1209(c) (LexisNexis 2006); MINN. STAT. ANN. § 302A.251(b)(4) (West 2004 & Supp. 2007); MISS. CODE ANN. § 79-4-2.02(b)(4) (2001); MO. ANN. STAT. § 351.055(9) (West 2001); MONT. CODE ANN. § 35-1-216(2)(d) (2006); NEB. REV. STAT. § 21-2018(2)(d) (2006); N.M. STAT. ANN. § 53-12-2(E) (LexisNexis 2004); N.Y. BUS. CORP. LAW § 402(b) (McKinney 2003); N.C. GEN. STAT. § 55-2-02(b)(3) (2005); N.D. CENT. CODE § 10-19.1-50(5) (2005); OKLA. STAT. ANN. tit. 18, § 1006(B)(7) (West 1999 & Supp. 2007); OR. REV. STAT. § 60.047(2)(d) (2005); S.C. CODE ANN. § 33-2-102(e) (2006); TENN. CODE ANN. § 48-12-102(b)(3) (2002); TEX. REV. CIV. STAT. ANN. art. 1302-7.06(B) (Vernon 2003); VT. STAT. ANN. tit. 11A, § 2.02(b)(4) (1997); W. VA. CODE ANN. § 31D-2-202(b)(4) (LexisNexis 2003 & Supp. 2007); WYO. STAT. ANN. § 17-16-202(b)(iv) (2005). The following statutes also provide liability protection for officers: LA. REV. STAT. ANN. § 12:24(c)(4) (2005); ME. REV. STAT. ANN. tit. 13-C, § 202(2)(D) (2006); MD. CODE ANN., CORPS, & ASS'NS § 2-405.2 (LexisNexis 1999); NEV. REV. STAT. § 78.138(7) (2004); N.H. REV. STAT. ANN. § 292:2(V-a) (LexisNexis 1999); N.J. STAT. ANN. § 14A:2-7(3) (West 2003); VA. CODE ANN. § 13.1-692.1 (2006). Exculpation is provided automatically by FLA. STAT. ANN. § 607.0831(3) (West 2001); IND. CODE ANN. § 23-1-35-1(e) (LexisNexis 1999); OHIO REV. CODE ANN. § 1701.59(C) (2004). Wisconsin automatically provides for exculpation, unless the corporation provides otherwise. WIS. STAT. ANN. § 180.0828 (West 2002). The following statutes permit exculpatory language in the corporate bylaws. HAW. REV. STAT. § 414-32(b)(5) (2004); UTAH CODE ANN. § 16-10a-841(1) (2005); VA. CODE ANN. § 13.1-692.1 (2006).

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

121. *Id.*

122. 906 A.2d 27 (Del. 2006) (holding that the board of directors did not

Disney directors was that they were not adequately informed of the value of the severance package that would be paid to President Michael Ovitz in the event of a no-fault termination of his employment contract.¹²³ Moreover, the plaintiffs further alleged that such failure by the directors to fully inform themselves regarding the potential payout of the no-fault termination provision of the contract evidenced lack of good faith.¹²⁴ The allegation regarding lack of good faith was important in this case because even if the Disney directors violated the duty of care, the shareholders would not be entitled to recover monetary damages unless they showed the directors' lack of good faith.¹²⁵ The articles of incorporation of Disney included a Section 102(b)(7)-type provision exculpating the Disney directors for monetary liability to the corporation and the shareholders for fiduciary violations not involving breach of loyalty, lack of good faith, or intentional misconduct.¹²⁶

The Chancery Court, however, found that the directors were adequately informed regarding the Ovitz employment contract, and its decision was affirmed by the Delaware Supreme Court.¹²⁷ It was important to both courts that the directors were apprised of the material facts. Although, as noted by the Chancery Court, the directors' practices were not best practices, they did not fall so short as to constitute gross negligence.¹²⁸

While a number—albeit not a large number—of cases have been decided defining the scope of the corporate director's fiduciary duty, there are fewer cases in Delaware involving the scope of the officer's duty.¹²⁹ Moreover, in cases where the duty of the officer is discussed, it is most often mentioned only in dicta in cases involving the liability of directors.¹³⁰ That is, courts often do not distinguish between the duties of an officer versus those of a director, and discuss the duties of officers and directors as if the two are inextricably linked. This approach originated in the days preceding

breach a duty of good faith by hiring and shortly thereafter terminating an employee with a generous severance package).

123. *Id.* at 46.

124. *Id.*

125. *Id.* at 65.

126. *Id.* at 46 n.37.

127. *Id.* at 56.

128. *Id.* at 72–74.

129. See Lawrence A. Hamermesh & A. Gilchrist Sparks III, *Corporate Officers and the Business Judgment Rule: A Reply to Professor Johnson*, 60 BUS. LAW. 865, 867 (2005) [hereinafter Hamermesh & Sparks 2005]; Lyman P.Q. Johnson & David Millon, *Recalling Why Corporate Officers are Fiduciaries*, 46 WM. & MARY L. REV. 1597, 1601 (2005).

130. Johnson & Millon, *supra* note 129, at 1610–11.

the governance practice of appointing a majority of independent directors to the board. Thus, it may have been true in the earlier cases that all the directors were officers—so that they were in fact inextricably linked.

More recently, some federal district courts, purportedly applying Delaware law, have found that an officer's duties are the same as a director's.¹³¹ It may be true that the Delaware judiciary sees no reason to distinguish between the fiduciary duty of care required of directors and officers. The law, however, has not yet been so clearly articulated by the Delaware courts.

A number of reasons have been advanced to explain the paucity of Delaware cases involving the duty of care of officers. Mr. Sparks and Professor Hamermesh explain that such claims may only be brought by shareholders through the derivative suit mechanism, and that the demand requirements effectively bar such litigation.¹³² In addition, Professor Johnson notes that although the board may bring suit against officers, the board has other means at its disposal to discipline corporate officers without resorting to litigation.¹³³ These methods include enforcement of contractual provisions, which may result in termination, compensation penalties, or other negative employment consequences.¹³⁴ Furthermore, the Delaware legislature has only somewhat recently conferred on the Delaware courts personal jurisdiction over officers.¹³⁵ Commentators have surmised that the lack of personal jurisdiction may account for the lack of cases against officers who were not also directors.¹³⁶ Yet, as noted by Professors Johnson and Millon, the causation issue may run in the other direction.¹³⁷ If no one believed officers "occupied] a

131. See Hamermesh & Sparks 2005, *supra* note 129, at 867 n.13 (citing *Stanziale v. Nachtomi*, No. Civ. A. 01-403 KAJ, 2004 U.S. Dist. LEXIS 7375 (D. Del. Aug. 6, 2004); *Grassmueck v. Barnett*, No. C03-122P, 2003 WL 22128263 (W.D. Wash. July 7, 2003); *Washington Bancorp. v. Said*, 812 F. Supp. 1256 (D.D.C. 1993)); see also A. Gilchrist Sparks, III & Lawrence A. Hamermesh, *Common Law Duties of Non-Director Corporate Officers*, 48 BUS. LAW. 215, 230 (1992) [hereinafter Sparks & Hamermesh 1992].

132. Hamermesh & Sparks 2005, *supra* note 129, at 867 n.13.

133. Lyman P.Q. Johnson, *Corporate Officers and the Business Judgment Rule*, 60 BUS. LAW. 439, 465-66 (2005); Johnson & Millon, *supra* note 129, at 1611-12.

134. Johnson & Millon, *supra* note 129, at 1611.

135. *Id.* at 1612 (citing DEL. CODE ANN. tit. 10, § 3114(b) (2007)).

136. See Johnson & Millon, *supra* note 129, at 1612 (citing William B. Chandler III & Leo E. Strine, Jr., *The New Federalism of the American Corporate Governance System: Preliminary Reflections of Two Residents of One Small State*, 152 U. PA. L. REV. 953, 1003 (2003); Hillary A. Sale, *Delaware's Good Faith*, 89 CORNELL L. REV. 456, 462 n.28 (2004)).

137. See Johnson & Millon, *supra* note 129, at 1613.

fiduciary status distinct from that of directors,” there would not have been a reason to confer jurisdiction over officers.¹³⁸

B. Genesis of Corporate Fiduciary Duties

The fiduciary duties of corporate law appear to have emanated from the duties inherent in trust and agency law. Elsewhere, we have reviewed the relevance of trust law to the genesis of corporate fiduciary duties, noting that although corporate directors and officers are not technically trustees of the corporation, the case law has analogized to the law of trusts in defining the scope of their fiduciary obligation.¹³⁹ For example, according to the Delaware Supreme Court, “[c]orporate officers and directors are not permitted to use their position of trust and confidence to further their private interests The rule that requires an undivided and unselfish loyalty to the corporation demands that there shall be no conflict between duty and self interest.”¹⁴⁰

According to the Restatement of Trusts, the duty of care of a trustee is the prudent investor standard, which requires that trustees exercise such care and skill as is reasonable in the circumstances, having particular regard for special knowledge or experience that the trustee has or claims to have.¹⁴¹ State courts and legislatures have reframed this duty as applied to directors as requiring directors to exercise the degree of care that ordinarily prudent persons would exercise under similar circumstances.¹⁴²

138. *Id.* Furthermore, now that the Chancery Court has jurisdiction over officers, “agency law provides the legal rationale for imposing fiduciary duties on corporate officers and can provide the theory supporting monetary claims by the corporation based on officer misconduct.” *Id.*

139. Muir & Schipani, *supra* note 110, at 444; see also Henry Ridgely Horsey, *The Duty of Care Component of the Delaware Business Judgment Rule*, 19 DEL. J. CORP. L. 971, 973 (1994); Edward Rock & Michael Wachter, *Dangerous Liaisons: Corporate Law, Trust Law, and Interdoctrinal Legal Transplants*, 96 NW. U. L. REV. 651, 651 (2002); L. S. Sealy, *Fiduciary Relationships*, 1962 CAMBRIDGE L.J. 69, 70 (1962); Justice Joseph T. Walsh, *The Fiduciary Foundation of Corporate Law*, 27 J. CORP. L. 333, 333 (2002).

140. *Guth v. Loft, Inc.*, 5 A.2d 503, 510 (Del. 1939). This language was also quoted recently by the Delaware Chancery Court in the recent litigation involving the Walt Disney Corporation. *In re Walt Disney Co. Derivative Litig.*, 907 A.2d 693, 751 (Del. Ch. 2005), *aff'd*, 906 A.2d 27 (Del. 2006).

141. RESTATEMENT (SECOND) OF TRUSTS § 174 (1959).

142. See, e.g., *Graham v. Allis-Chalmers Mfg. Co.*, 188 A.2d 125, 130 (Del. 1963) (noting that “directors of a corporation in managing the corporate affairs are bound to use that amount of care which ordinarily careful and prudent men would use in similar circumstances”); see also Michael Bradley & Cindy A. Schipani, *The Relevance of the Duty of Care Standard in Corporate Governance*, 75 IOWA L. REV. 1, 17–19 (1989); Krishnan Chittur, *The Corporate Director’s Standard of Care: Past, Present and Future*, 10 DEL. J. CORP. L. 505, 508 (1985);

Many states have codified the duty of care.¹⁴³

While trust law seems highly relevant to the obligations of directors, agency law may be less relevant to their duties. Directors are not considered agents of either the corporation or of the shareholders.¹⁴⁴ According to the Restatement (Third) of Agency, “[a]lthough a corporation’s shareholders elect its directors and may have the right to remove directors once elected, the directors are neither the shareholders’ nor the corporation’s agents as defined in this section, given the treatment of directors within contemporary corporation law in the United States.”¹⁴⁵ The Restatement further explains that “corporation law generally invests managerial authority over corporate affairs in a board of directors, not in shareholders, providing that management shall occur by or under the board of directors. Thus shareholders ordinarily do not have a

Horsey, *supra* note 139, at 978 (quoting George W. Dent, Jr., *The Revolution in Corporate Governance, the Monitoring Board, and the Director’s Duty of Care*, 61 B.U. L. REV. 623, 647 (1981)).

143. See ALASKA STAT. § 10.06.450 (2006); ARIZ. REV. STAT. ANN. § 10-830 (2004); CAL. CORP. CODE § 309 (Deering Supp. 2007); CONN. GEN. STAT. ANN. § 33-756 (West 2005); FLA. STAT. ANN. § 607.0830 (West 2001); GA. CODE ANN. § 14-2-830 (2003); HAW. REV. STAT. § 414-221 (2004); IOWA CODE ANN. § 490.830 (West 1999 & Supp. 2007); KY. REV. STAT. ANN. § 271B.8-300 (LexisNexis 2003); LA. REV. STAT. ANN. § 12:91 (1994); ME. REV. STAT. ANN. tit. 13-C, § 831 (2005); MD. CODE ANN., CORPS. & ASS’NS § 2-405.1 (LexisNexis 1999); MASS. ANN. LAWS ch. 156B, § 65 (LexisNexis 2005); MICH. COMP. LAWS SERV. § 450.1541a (LexisNexis 2006); MINN. STAT. ANN. § 302A.251 (West 2004 & Supp. 2007); MISS. CODE ANN. § 79-4-8.42 (2001); MONT. CODE ANN. § 35-2-441 (2005); N.H. REV. STAT. ANN. § 293-A:8.30 (LexisNexis 2001); N.J. STAT. ANN. § 14A:6-14 (West 2003); N.M. STAT. ANN. § 53-4-18.1 (LexisNexis 2004); N.Y. BUS. CORP. LAW § 717 (McKinney 2003); N.C. GEN. STAT. § 55-8-30 (2005); N.D. CENT. CODE § 10-19.1-50 (2005); OHIO REV. CODE ANN. § 1701.59 (LexisNexis 2004); OR. REV. STAT. § 60.357 (2005); 15 PA. CONS. STAT. ANN. § 1712 (West 1995); S.C. CODE ANN. § 33-8-300 (2006); TENN. CODE ANN. § 48-18-301 (2002); VA. CODE ANN. § 13.1-690 (2006); WASH. REV. CODE ANN. § 23B.08.300 (West 1994); W. VA. CODE ANN. § 31D-8-830 (LexisNexis 2003); WYO. STAT. ANN. § 17-16-830 (2005).

144. See, e.g., Johnson & Millon, *supra* note 129, at 1636–39; Jones, *supra* note 108 (citing Eric W. Orts, *Shirking and Sharking: A Legal Theory of the Firm*, 16 YALE L. & POL’Y REV. 265, 309–12 (1998)).

145. RESTATEMENT (THIRD) OF AGENCY § 1.01 cmt. f(2) (2006). The Restatement also states:

[a] director, may of course, also be an employee or officer (who may or may not be an employee) of the corporation, giving the director an additional and separate conventional position or role as an agent. Fellow directors may, with that director’s consent, appoint a director as an agent to act on behalf of the corporation in some respect or matter.

Id.

right to control directors by giving binding instructions to them.”¹⁴⁶

Officers, however, would appropriately be considered agents,¹⁴⁷ and agency law thus informs the scope of their duties.¹⁴⁸ Officers are designated by the board as agents of the corporation, vested with the power to exercise judgment. For example, as noted by Sparks and Hamermesh, a corporate officer has been defined as a person “in whom administrative and executive functions have been entrusted.”¹⁴⁹ Furthermore, an officer is someone who is in a position to exercise judgment and discretion in decision making.¹⁵⁰

Similar to, although less exacting than, the duty of care of trustees, the duty of care of agents is described in the Restatement (Third) of Agency as “a duty to the principal to act with the care, competence, and diligence normally exercised by agents in similar circumstances. Special skills or knowledge possessed by an agent are circumstances to be taken into account in determining whether the agent acted with due care and diligence.”¹⁵¹ The Comment to this section of the Restatement refers to statutory provisions that may further delineate the duties of a particular agent. In particular, the Comment refers to Section 8.42(a)(2) of the Model Business Corporation Act (“MBCA”), which describes the officer’s duty of care as “the care that a person in like position would reasonably exercise under similar circumstances.”¹⁵² Application of agency principles would, therefore, seem to call for application of a simple negligence standard to the conduct of corporate officers.¹⁵³ Furthermore, that standard takes into account the specific expertise of officers and holds officers with expertise to a standard

146. *Id.*

147. Johnson & Millon, *supra* note 129, at 1636; Jones, *supra* note 108.

148. Johnson & Millon, *supra* note 129, at 1636; Jones, *supra* note 108.

149. Sparks & Hamermesh 1992, *supra* note 131, at 216. Moreover, “[a]n individual expressly designated as an officer by the board of directors should, however, be presumed to be empowered to exercise judgment and discretion as to corporate matters, unless it is shown that the board did not intend to vest such authority.” *Id.* Similarly, Professor Langevoort notes that “[a]lmost every corporate employee with discretionary responsibilities is an agent, and agency principles are frequently invoked in corporate law disputes.” Donald C. Langevoort, *Agency Law Inside the Corporation: Problems of Candor and Knowledge*, 71 U. CIN. L. REV. 1187, 1191 (2003).

150. Sparks & Hamermesh 1992, *supra* note 131, at 216.

151. RESTATEMENT (THIRD) OF AGENCY § 8.08 (2006).

152. RESTATEMENT (THIRD) OF AGENCY § 8.08 cmt. b (2006) (quoting MODEL BUS. CORP. ACT ANN. § 8.42(a)(2)).

153. *See* Johnson, *supra* note 133, at 461. *But see* Rock & Wachter, *supra* note 139, at 663–68 (arguing that agency and trust law principles have not transferred well to corporate law).

commensurate with their abilities.¹⁵⁴

One point of potential divergence in the duty of care analysis between directors and officers seems to be whether the standard of care is one of simple or gross negligence. The Delaware Supreme Court has stated that the applicable standard for the conduct of directors is one of gross negligence.¹⁵⁵ There is no similar definitive standard, however, with respect to officers. If agency law does indeed provide the relevant standard, the simple negligence standard seems to be the default standard for officers. Courts could, of course, alter the standard to align it with the standard for directors. As discussed above, some commentators argue that there is no difference between the standard of care required of officers and directors. Either way, whether the standard is simple or gross negligence, agency law allows for consideration of specific expertise and knowledge of the officers when considering liability for breach of the duty of care.

C. *The Use of Deferential Standards: The Business Judgment Rule*

Confusing the analysis further is the question of the applicability of the doctrine commonly known as the business judgment rule to the duty of care. The business judgment rule is a presumption that the directors acted in good faith with the reasonable belief that their actions were in the best interest of the corporation.¹⁵⁶ To its credit, the business judgment rule has prevented courts from second-guessing honest, good faith business decisions in cases lacking allegations of a breach of the duty of loyalty or intentional misconduct.¹⁵⁷ As such, the gross negligence

154. Professor Langevoort also notes that:

an agent is subject to a duty to use reasonable efforts to give his principal information which is relevant to affairs entrusted to him and which, as the agent has notice, the principal would desire to have and which can be communicated without violating a superior duty to a third person.

Langevoort, *supra* note 149, at 1194 (quoting RESTATEMENT (THIRD) OF AGENCY § 318 (1957)).

155. *Smith v. Van Gorkom*, 488 A.2d 858, 881 (Del. 1985).

156. *See, e.g., Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984) (defining the business judgment rule); *In re Compucom Systems, Inc., Stockholders Litig.*, No. Civ. A. 499-N, 2005 WL 2481325, at *1 (Del. Ch. Sept. 29, 2005) (applying the business judgment rule presumption); *Davis v. Louisville Gas & Elec. Co.*, 142 A. 654, 659 (Del. Ch. 1928) (defining the business judgment rule as a “presumption that [the director’s judgment] was formed in good faith and . . . to promote the best interests of the corporation [the directors] serve”).

157. *See, e.g., Shlensky v. Wrigley*, 273 N.E.2d 776, 781 (Ill. App. 1968) (holding that courts cannot impose their independent business judgment absent “a clear showing of dereliction of duty on the part of specific directors”).

standard applicable to the directors' conduct has emerged from this presumption.¹⁵⁸ That is, absent bad faith, plaintiffs must prove behavior amounting to at least a gross negligence standard of culpability in order to state a claim. Facts supporting a claim of simple negligence are not sufficient to overcome the presumption.

The business judgment rule has been a confusing concept in corporate law. The confusion stems from the issue of whether it is simply a doctrine that prevents courts from second-guessing good faith business decisions or whether it is a standard of care. For example, according to Professor Bainbridge, the rule is not a rule, but is instead a standard.¹⁵⁹ Furthermore, Professor Bainbridge finds that "[t]he question is not whether the directors violated some bright-line precept, but whether their conduct satisfied some standard for judicial abstention."¹⁶⁰ Regardless, the business judgment rule, together with the gross negligence standard of care, has been applied by the courts to limit the potential liability of directors.¹⁶¹ Courts appear reluctant to second-guess good faith business decisions. Instead, courts tend to focus the duty of care analysis on the decision-making process, rather than the substantive decision.¹⁶²

One of the justifications given in support of the business judgment rule is that without it, corporations would not be able to attract well-qualified people to serve on boards.¹⁶³ That is, the rewards of serving as a director would not be worth the risk of the liability that might ensue if courts more strictly scrutinized business decisions.¹⁶⁴ In addition, the rule is said to enable corporate boards to undertake business risks.¹⁶⁵ It is feared that without the protections of the rule, directors would be prone to approve only low-risk projects when a higher level of risk would be more appropriate.

It is a debated question whether the business judgment rule and the concomitant gross negligence standard of care as established for directors should be applied in a similar fashion to officers.¹⁶⁶ On one hand, Mr. Sparks and Professor Hamermesh

158. *See, e.g., Van Gorkom*, 488 A.2d at 873.

159. STEPHEN M. BAINBRIDGE, *CORPORATION LAW AND ECONOMICS* 283 (2002).

160. *Id.*

161. *Id.*

162. *Id.*

163. Johnson, *supra* note 133, at 458; *see also* Hal R. Arkes & Cindy A. Schipani, *Medical Malpractice v. the Business Judgment Rule: Differences in Hindsight Bias*, 73 OR. L. REV. 587, 622 (1994) (discussing rationales justifying the business judgment rule).

164. Johnson, *supra* note 133, at 458.

165. *Id.* at 459.

166. Deborah A. DeMott, *Inside the Corporate Veil: The Character and*

argue that the rule should be applied to officers in the same way that it has been applied to directors, and that the standard of care for officers should likewise be one of gross negligence.¹⁶⁷ Sparks and Hamermesh also note that the conduct of officers may be more closely scrutinized than that of directors because they are privy to corporate information.¹⁶⁸ They refer to the Official Comment to Section 8.42 of the MBCA, which states that although the standard of care applied to non-director officers with discretionary authority is the same as that applied to directors, non-director officers are less able to rely on information provided by others and may be required to be more informed about corporate affairs.¹⁶⁹

Yet, Sparks and Hamermesh argue that the business judgment rule, as applied to directors, should also apply to officers.¹⁷⁰ They note first that without business judgment rule protection for officers, the policy of the rule—to avoid second-guessing of management—would be imperiled.¹⁷¹ That is, boards delegate decision making to officers. If the officer is not protected, the board’s decision to delegate is therefore not protected. Ultimately, failure to apply the business judgment rule to the decisions of officers would therefore nullify the protection given to directors to delegate decision making.

Professor Bainbridge also finds that the better view is to apply the business judgment rule to officers. He finds that “[m]ost of the theoretical justifications for the business judgment rule extend from the boardroom to corporate officers.”¹⁷² In addition, corporate officers may be even more risk averse than members of the board.¹⁷³ Bainbridge further analogizes both the board of directors and top management to production teams and, as such, “internal governance may be preferable to external review.”¹⁷⁴

Although Sparks and Hamermesh thus argue in favor of

Consequences of Executives’ Duties 16 (Duke Law Sch. Legal Studies Research Paper Series, Research Paper No. 112, 2006), available at <http://ssrn.com/abstract=918524>.

167. Hamermesh & Sparks 2005, *supra* note 129, at 865; Sparks & Hamermesh 1992, *supra* note 131, at 229–30.

168. Sparks & Hamermesh 1992, *supra* note 131, at 218.

169. *Id.* (citing MODEL BUS. CORP. ACT ANN. § 8.42 cmt. (3d ed. Supp. 2005)).

170. *Id.* at 217. Professor Langevoort also presumes that “officers, like directors, are protected by the business judgment rule, protecting them against claims of simple negligence when a decision turned out poorly.” Langevoort, *supra* note 149, at 1203. Langevoort argues that officers have a duty of candor, which “superimpose[s] an obligation to warn directors of risks that are material to the board’s level of attention, regardless of their justification.” *Id.*

171. Sparks & Hamermesh 1992, *supra* note 131, at 237.

172. BAINBRIDGE, *supra* note 159, at 286.

173. *Id.*

174. *Id.*

business judgment rule protection for officers, their support of the business judgment rule in this context is not unlimited. They recognize that the business judgment rule should not apply to officers who act outside of delegated board authority.¹⁷⁵ Furthermore, just as applied to the behavior of directors, the business judgment rule should not be invoked to protect actions of officers that involve conflicts of interest.¹⁷⁶

Professor Johnson, on the other hand, disagrees with Sparks and Hamermesh regarding the applicability of the business judgment rule to officers, although agreeing that courts should not second-guess the good faith business decisions of officers.¹⁷⁷ Professor Johnson instead argues that a simple negligence standard of care should govern the behavior of officers.¹⁷⁸ One point of agreement among Sparks, Hamermesh, and Johnson is that although some Delaware courts have assumed that the rule applies to officers, these rulings are not definitive.¹⁷⁹

Professor Johnson considers the three main justifications for the applicability of the business judgment rule to directors and concludes that these reasons do not justify applicability of the rule to officers. First, Professor Johnson doubts that officers need the protection of the business judgment rule in order to take appropriate risks. Instead, he finds that due to the nature of executive compensation packages, “officers, unlike directors, stand to reap substantial rewards for taking appropriate risks.”¹⁸⁰ In addition, Professor Johnson argues that officers should face greater risks than directors.¹⁸¹

175. Hamermesh & Sparks 2005, *supra* note 129, at 876.

176. *Id.*

177. Johnson, *supra* note 133, at 452, 456–57.

178. *Id.* at 466.

179. Sparks & Hamermesh 1992, *supra* note 131, at 232 & nn.107–08 (citing *Lewis v. Aronson*, 466 A.2d 375, 381 (Del. Ch. 1983), *rev'd on other grounds*, 473 A.2d 805 (Del. 1984); *Pogostin v. Rice*, No. 6235, 1983 WL 17985 (Del. Ch. Aug. 12, 1983), *aff'd*, 480 A.2d 619 (Del. 1984); *Haber v. Bell*, 465 A.2d 353, 357 (Del. Ch. 1983); *Schreiber v. Pennzoil Co.*, 419 A.2d 952, 956 (Del. Ch. 1980). Professor Johnson has made a similar point. See Johnson, *supra* note 133, at 443–44 & nn. 30–41 (citing *Cinerama, Inc. v. Technicolor, Inc.* 663 A.2d 1156, 1162 (Del. 1995); *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 361 (Del. 1993); *Kelly v. Bell*, 266 A.2d 878 (Del. 1970); *Kaplan v. Centex Corp.*, 284 A.2d 119, 124–25 (Del. Ch. 1971)); see also *In re Walt Disney Co. Derivative Litig.*, No. 15452, 2004 Del. Ch. LEXIS 132, at *14 (Del. Ch. Sept. 10, 2004), *aff'd* 906 A.2d 27 (Del. 2006) (“To date, the fiduciary duties of officers have been assumed to be identical to those of directors.”).

180. Johnson, *supra* note 133, at 459.

181. *Id.* at 460.

Officers work for the company full time, possess extensive knowledge and skill concerning company affairs, have access to considerably more and better information than directors, enjoy high company and social status, and exercise great influence over the lives of many people. . . . They should be held to the same standard of care as are all other persons who serve as agents of companies—a duty of ordinary care.¹⁸²

Professor Johnson further presents an interesting dilemma that arises if the business judgment rule also applies to officers. That is, in the case where directors decide to pursue a claim of breach of fiduciary duty against officers, should the courts apply the business judgment rule to the directors' judgment in pursuing the claim against the officers, or should the court apply the business judgment rule to the behavior of the officers?¹⁸³ To apply the business judgment rule to the conduct of the officers in this context would undermine the board's decision to hold its agents accountable.¹⁸⁴

Professor Johnson goes on to argue that directors may enter employment agreements with officers to modify the fiduciary duty standard—either to weaken the standard to a gross negligence standard or to eliminate either the duty or monetary liability for a breach of the duty.¹⁸⁵ In conclusion, Professor Johnson states that “civil liability can remind officers that stockholders and directors likewise expect adherence to basic fiduciary standards, without undeserved refuge in the business judgment rule.”¹⁸⁶

To the extent the business judgment rule is simply a presumption that absent conflicts of interest, breach of the duty of loyalty, or intentional misconduct, corporate actors have acted in good faith and in the best interest of the corporation, we see no reason to deny corporate officers the benefit of this presumption. Courts have been reluctant to substitute their business judgment for that of corporate directors under such circumstances, and there does not seem to be a reason why they should do so when the business decision has been made by a corporate officer.

Yet, it is not clear that gross negligence should be the applicable standard of care. Although we take as a given that the corporate law applies a gross negligence standard in the context of director misconduct, we understand the parameters of scrutiny for officer and executive fiduciary breaches are yet to be resolved. Courts may defer to good faith, honest business decisions, as promoted by

182. *Id.*

183. *Id.* at 464.

184. *Id.*

185. *Id.* at 466–67.

186. *Id.* at 469.

Professor Johnson,¹⁸⁷ but still hold officers responsible for negligence in the decision-making process. This standard might be justified given the expectations of behavior pursuant to agency law. The agency standard is one of simple negligence, which requires courts to evaluate the reasonableness of the care under the circumstances. There are differences in the circumstances between the roles of officers versus directors. For example, unlike directors, officers work for the corporation full-time and have direct access to information. There is less necessity to rely on information provided by others. As such, the simple negligence standard vis-à-vis the decision-making process may help correlate responsibility with liability, given the context of the day-to-day responsibilities of executive officers.

Professor Bainbridge frames the business judgment rule in terms of the need for courts to balance authority and accountability in specific circumstances.¹⁸⁸ He sees the Delaware courts moving in this direction due to variances in the level of judicial review afforded in a particular case, which depend “upon the specific context that gives occasion to the board’s exercise of business judgment.”¹⁸⁹

Professor DeMott notes that while boards of companies may include directors without operational expertise, officers are required to have expertise.¹⁹⁰ Accordingly, the business judgment rule does not fit neatly with the various roles of executives, especially considering that executives are expected to take actions in accordance with their expertise.¹⁹¹

Our review of the case law pertaining to directors leads us to conclude that regardless of whether future courts frame the standard of care in terms of a simple or a gross negligence standard, it is likely that they will also more closely evaluate the obligations of officers in the context of their corporate responsibilities. We see this scrutiny occurring in both the due care and loyalty contexts. In the end, the care standard applicable to the conduct of officers may prove to be a standard that differs from what we have seen applied in the director context and in some ways may closely parallel the ERISA standards. In the next Section, we take a look at three

187. *Id.* at 465.

188. BAINBRIDGE, *supra* note 159, at 283.

189. *Id.* (quoting *McMullin v. Beran*, 765 A.2d 910, 918 (Del. 2000)).

190. DeMott, *supra* note 166, at 25.

191. *Id.* at 24. DeMott further notes that “the rule appears disconnected from the world of work.” *Id.* In addition, a question is raised, in the context of executives, regarding whether the rule protects only actions that were authorized. This issue is not as clear as it might at first appear. Instructions that might seem unambiguous to the supervisor may not be unambiguous to the executive attempting to execute the instructions. *Id.* at 24–25.

seemingly unrelated areas of corporate law that support this approach.

D. The Relevance of Expertise

There seems to be precedent in corporate law for a contextual approach in determining how closely the courts should scrutinize the obligations of directors. That is, in certain contexts, the courts have considered the specific expertise of directors and the scope of their obligations to the public trust when deciding whether fiduciary obligations have been breached. Subsection 1 considers this issue in the context of the duty of loyalty and good faith with examination of the decision of the Delaware Chancery court in the *ECM* case.¹⁹² Subsection 2 recalls cases from the 1930s and 1940s, picked up by some contemporary courts in the 1990s, where various state and federal courts wrestled with the duty of care standard applicable to directors of financial institutions. Subsection 3 returns to recent case law highlighting two Delaware decisions regarding the scope of independence of directors. From these contextual analyses, we infer that courts may similarly take a contextual approach to evaluating the surrounding facts and circumstances relevant to the fiduciary obligations of officers. The context of facts and circumstances may ultimately become highly relevant to courts as they delineate how closely they should scrutinize the scope of officers' fiduciary duties with an eye toward correlating liability with responsibility.

1. In re Emerging Communications, Inc. ("ECM")

In *ECM*, the board of directors of Emerging Communications, Inc. ("ECM") was sued by former minority shareholders alleging breach of the duties of care, loyalty, and good faith in the directors' approval of the going private transaction.¹⁹³ The going private transaction was found to have been unfair both in the price paid to the minority shareholders and in the process used to set the price.¹⁹⁴ The court evaluated the nature of fiduciary duties of each board member individually. One of the unique findings of this case involved the fiduciary liability of the members of the board. The court proceeded to find the CEO and Chairman of the Board in violation of his duties because he set up the unfair transaction in order to personally benefit.¹⁹⁵

The court then considered the liability of the director who was

192. *In re Emerging Commc'ns, Inc. S'holder Litig. [ECM]*, No. 16415, 2004 Del. Ch. LEXIS 70 (Del. Ch. May 3, 2004).

193. *Id.* at *35-36.

194. *Id.* at *42-137.

195. *Id.* at *140.

the personal attorney of the CEO as well as the company's counsel.¹⁹⁶ This director was held to violate his fiduciary duties because he acted to further his own economic interests.¹⁹⁷ His economic interests and loyalties were tied to those of the CEO.¹⁹⁸

The most interesting finding of liability was the breach of fiduciary duty of Mr. Muoio, a director who was also an investment banker. Muoio had substantial expertise in finance and in the telecommunications sector.¹⁹⁹ Such expertise prompted the court to find him liable for breach of the fiduciary duty of loyalty or good faith because he should have recognized that the transaction was unfair.²⁰⁰ According to the court, this director was liable "because he voted to approve the transaction even though he knew, or at the very least had strong reasons to believe, that the \$10.25 per share merger price was unfair."²⁰¹ Thus, based on his experience, Muoio was obligated, although a majority of the board was not so obligated, to recognize that the merger price was unfair and to vote against the transaction.²⁰² In other words, the court held Muoio liable because his experience should have alerted him to the unfairness of the price. On the other hand, the court did not find that the remaining, less-experienced directors had violated their fiduciary duties, presumably because they did not possess special knowledge, which would have put them on notice of the unfairness of the transaction.²⁰³

It is also worth noting that Muoio was held liable for breach of the duty of loyalty and good faith. The parameters of the duty of good faith had not yet been decided in Delaware, and the court did not find it necessary to determine whether good faith was a stand-alone duty or linked to another duty. Furthermore, due to the Section 102(b)(7)-type provision in ECM's articles of incorporation protecting ECM's directors from monetary liability for breach of the

196. *Id.* at *121.

197. *Id.* at *122–23.

198. *Id.* at *142.

199. *Id.* at *143.

200. *Id.*; see also Harvey L. Pitt, *The Changing Standards by Which Directors Will Be Judged*, 79 ST. JOHN'S L. REV. 1, 5 (2005); E. Norman Veasey, *Musings From the Center of the Corporate Universe*, 7 DEL. L. REV. 163, 172 (2004).

201. *ECM*, 2004 Del. Ch. LEXIS 70, at *143.

202. *Id.* at *144–45.

203. *Id.* at *148; see also *Canadian Commercial Workers Indus. Pension Plan v. Alden*, No. 1184-N, 2006 Del. Ch. LEXIS 42, at *29 n.54 (Del. Ch. Feb. 22, 2006) (noting that *ECM* held "that a director with *financial expertise* and 'in a unique position to know' should have argued more vociferously that the \$10.25 price of a proposed transaction was unfair . . . and that the director was not independent").

duty of care, the court in *ECM* focused its analysis on the duty of loyalty and good faith rather than the duty of care.²⁰⁴

This case is particularly interesting in the approach the court used to correlate liability with knowledge and expertise.²⁰⁵ To the extent Muoio knew or should have known that the price set by the CEO was unfair, it follows that liability should ensue. Yet, the case is troubling to the extent it singles out a director for his personal expertise. There seems to be serious risk that persons with the specific expertise needed in a corporate boardroom may shy away from serving on boards if they are held to a higher standard of care. Conversely, from a policy perspective, board members should not be encouraged to check their expertise at the door when entering the boardroom. The shareholders presumably elected the board members to utilize their expertise and experiences in making corporate decisions.

As mentioned above, *ECM* was decided as a loyalty and good faith case rather than a due care case. The company's articles of incorporation exonerated the board members from liability for breach of the duty of care. If a similar case alleging a due care violation were to be brought against an officer possessing expertise that established that he or she should have known that the decision was not in the best interest of the corporation, it seems that such knowledge would be relevant to the surrounding facts and circumstances of the decision-making process. Although it may be appropriate to apply business judgment rule deference in avoiding second-guessing of good faith, honest business decisions, it would still be fair to consider the surrounding facts and circumstances as they affect the decision-making process. As made clear by the Delaware Supreme Court in *Smith v. Van Gorkom*²⁰⁶ and more recently in *In re Walt Disney*,²⁰⁷ regardless of the business judgment rule presumption, the duty of care requires gathering of all reasonably available information before making a business decision. Reasonably available information would include information

204. See Muir & Schipani, *supra* note 110, at 447–52 for further discussion of the duty of loyalty and/or good faith as discussed in *ECM*.

205. See Pitt, *supra* note 200, at 4–5 (discussing *ECM* and noting that the case implies that “those with special expertise need to take extra care if they wish their utilization of and reliance on outside experts to exculpate them from liability”). *But see* 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, 1445–48 (2005) (noting that *ECM* should not be interpreted to mean that those with more expertise will be held to a higher standard).

206. 488 A.2d 858, 873 (Del. 1985).

207. *In re Walt Disney Co. Derivative Litig.*, 906 A.2d 27, 60–62 (Del. 2006).

correlated to expertise and responsibility.

2. *Bank Director Cases*

Another area of corporate law where the courts have found specific contexts relevant to the fiduciary duty analysis of directors involves the obligations of bank directors, particularly in the days preceding the availability of deposit insurance.²⁰⁸ The basic fact pattern of these cases often involved intentional wrongdoing by officers or other members of management that went undetected by the board. Under these circumstances, the board members were held liable for failure to control and supervise the affairs of the bank. Although case law does not directly hold that there is a higher standard of care applicable to directors of financial institutions, the courts did find liability for the failure of bank directors to exercise the ordinary care and diligence of an ordinarily prudent person acting in similar circumstances.²⁰⁹ These circumstances included added responsibility for depositors' accounts. This responsibility required the bank directors to exercise

208. See Cindy A. Schipani, *Should Bank Directors Fear FIRREA: The FDIC's Enforcement of the Financial Institutions Reform, Recovery and Enforcement Act*, 17 J. CORP. L. 739, 748-51 (1992). The Federal Deposit Insurance Corporation was established by the Congress in 1933, during the Great Depression. FDIC: Federal Deposit Insurance Corporation, Who is the FDIC?, <http://fdic.gov/about/learn/symbol/index.html> (last visited July 11, 2007).

209. See, e.g., *Atherton v. Anderson*, 99 F.2d 883, 887 (6th Cir. 1938) (referring to the standard articulated in *Briggs v. Spaulding*, 141 U.S. 132, 152 (1891)); see also *Fed. Deposit Ins. Corp. v. Mason*, 115 F.2d 548, 551 (3d Cir. 1940) (“[B]ank directors have a duty . . . to exercise ordinary care and prudence in the administration of the affairs of their bank.”); *Bourne v. Perkins*, 42 F.2d 94, 98 (8th Cir. 1930) (describing bank directors standard of care); *Cory Mann George Corp. v. Old*, 23 F.2d 803, 807-08 (4th Cir. 1928) (referring to the standard of care articulated in *Briggs*); *Gamble v. Brown*, 29 F.2d 366, 370 (4th Cir. 1928) (referring to the standard of care articulated in *Bowerman v. Hamner*, 250 U.S. 504 (1919)); *Mullins v. De Soto Sec. Co.*, 56 F. Supp. 907, 911 (W.D. La. 1944) (discussing the degree of care required for officers and directors); *Ringeon v. Albinson*, 35 F.2d 753, 754 (D. Minn. 1929) (articulating bank directors' degree of care); *Proksch v. Bettendorf*, 257 N.W. 383, 384 (Iowa 1934) (describing director liability); *Goodwin v. Simpson*, 197 N.E. 628, 630 (Mass. 1935) (same); *Barber v. Kolowich*, 275 N.W. 797, 799 (Mich. 1937) (same); *Trembert v. Mott*, 261 N.W. 109, 113 (Mich. 1935) (same); *Liffiton v. Nat'l Sav. Bank*, 44 N.Y.S. 2d 770, 776 (N.Y. App. Div. 1943) (holding that the bank officers were “required . . . to exercise a degree of care commensurate with the evil to be avoided”); *Gallin v. Nat'l City Bank*, 281 N.Y.S. 795, 806 (N.Y. Sup. Ct. 1935) (noting that the standard is whether the directors “exercise[d] the care and caution which would be exercised by a prudent man in handling his own affairs”); *Anderson v. Bundy*, 171 S.E. 501, 506 (Va. 1933) (describing the duty of care directors must exercise); *Williams v. Fidelity Loan & Sav. Co.*, 128 S.E. 615, 622 (Va. 1925) (same).

reasonable control and supervise the affairs of the banks.

For example, in *Atherton v. Anderson*, the Court of Appeals for the Sixth Circuit, in 1938, held that one of the purposes of the bank is to safely hold the money of the depositors.²¹⁰ *Atherton* involved a fraud perpetrated by the president and cashier of the bank.²¹¹ The directors were sued by the receiver for violation of their duty of due care.²¹² The court noted that depositors had a right to expect that the directors would maintain “reasonable control and supervision over the affairs of the Bank, especially its larger and more important ones.”²¹³ The court further noted that a national bank is not a private corporation in which shareholders alone are interested, but a quasi-governmental agency.²¹⁴

In *Billman v. Maryland Deposit Insurance Fund Corp.*, the court upheld a jury instruction regarding a stricter standard of care applicable to the duty owed by the directors of a savings and loan institution.²¹⁵ The reason behind the stricter standard was the entrustment of funds belonging to the general public.²¹⁶ The appellate court effectively found that the care obligation should correlate to the responsibilities inherent in the enterprise—which in this case included the responsibility for the savings of others.²¹⁷

Application of a higher standard of liability to bank directors has been challenged and upheld in New York. In *Resolution Trust Corp. v. Gregor*, the court addressed the view presented by the defendant that the older bank director cases have “lost their vitality” in the wake of the business judgment rule.²¹⁸ The court

210. *Atherton*, 99 F.2d at 888.

211. *Id.* at 887.

212. *Id.* at 886–87.

213. *Id.* at 888.

214. *Id.*; see also *Hopkins Fed. Sav. & Loan Ass’n v. Cleary*, 296 U.S. 315, 328 (1935) (explaining that building and loan associations in Wisconsin are “quasi-public corporations . . . with powers and immunities peculiarly their own”).

215. 593 A.2d 684, 697–98 (Md. Ct. Spec. App. 1991); see also *Fed. Deposit Ins. Corp. v. Stanley*, 770 F. Supp. 1281, 1310–11 (N.D. Ind. 1991) (noting the requirement that bank directors exercise reasonable control and supervision over the affairs of the bank, but further noting that bank directors are not insurers or guarantors).

216. *Stanley*, 770 F. Supp. at 1314.

217. *Billman*, 593 A.2d at 697–98. Arguments that the situation rather than the standard applied is what distinguishes the liability of bank directors from that of other directors have early roots. See, e.g., C.B. & S.B., *The Standard of Care Required of Saving Bank Directors*, 25 YALE L.J. 141, 143 (1915) (commenting on director liability and noting that “different kinds of business vary in the degree of care required to constitute reasonable prudence on the part of those conducting them”).

218. 872 F. Supp. 1140, 1151 (E.D.N.Y. 1994).

disagreed, finding no precedent for applying the business judgment rule to bank director cases.²¹⁹ Then, although acknowledging the defendant's assertion that courts rarely cite the old rule to apply a higher standard of liability to bank directors, the court did not find a compelling reason to rewrite law that has "remained unchanged for at least one hundred years."²²⁰

More recently, the court in *Federal Deposit Insurance Corp. v. Bober* faced a similar challenge.²²¹ Refusing to weaken the standard applied to bank directors, the court opined, "if the legislature intended to completely harmonize the standards to which bank directors and corporate directors are held, it presumably would have used exactly the same language."²²²

These cases involved the care required in the oversight function of directors, rather than the care required in business decision making. As such, these cases were not cases where business judgment rule deference would apply. They are interesting for our purposes, though, because of the significance of the facts and circumstances to the courts' analyses. It was apparently important to these courts that the directors not only serve the shareholders but also protect deposits. These courts appear to be equating responsibility with liability.

3. *Contemporary Cases on Independence*

Finally, a third context relevant to our inquiry is the deeper contextual analysis entertained by the Delaware courts when the independence of directors is at issue. For example, in *In re Oracle Corp. Derivative Litigation*, the Delaware Chancery Court was asked to decide whether the special litigation committee formed to determine whether the shareholders' derivative suit should be allowed to proceed was indeed an independent committee.²²³ The court found that the independence issue "turns on whether a director is, *for any substantial reason*, incapable of making a decision with only the best interests of the corporation in mind."²²⁴ In this case, the court not only considered whether the independent directors were directors of the company at the time of the facts giving rise to the dispute (they were not), but also delved further

219. *Id.*

220. *Id.*

221. 95 Civ. 9529 (JSM), 2002 U.S. Dist. LEXIS 13231 (S.D.N.Y. July 18, 2002).

222. *Id.* at *8.

223. 824 A.2d 917, 920 (Del. Ch. 2003).

224. *Id.* (quoting *Parfi Holding AB v. Mirror Image Internet, Inc.*, 794 A.2d 1211, 1232 (Del. Ch. 2001), *rev'd in part on other grounds*, 817 A.2d 149 (Del. 2002)).

into the interrelationships between members of the special litigation committee and the defendant directors.²²⁵ Here, the court found that all directors (both special litigation committee members and defendant directors) had significant ties to Stanford University.²²⁶ These ties to Stanford were enough to thwart the independence of the special litigation committee. The court held that the facts gave reasonable doubt as to whether the special litigation committee might be unable to render an impartial decision.²²⁷

Similarly, the Delaware Chancery Court in *In re eBay Shareholders Litigation*, found itself deciding whether a special litigation committee was independent.²²⁸ Again the standard for determining independence was whether the special litigation committee could be objective and impartial.²²⁹ There was significant concern that because the directors of the special litigation committee served at the pleasure of the defendant directors (the defendant directors were also majority shareholders), it was unlikely that these special litigation committee members could be impartial.²³⁰ Moreover, the special litigation committee members held options that required additional years of board service before vesting.²³¹ If the committee decided that the litigation should proceed against the defendant directors, the members of the special litigation committee risked the possibility that the defendant directors would terminate their positions as directors.²³² If these directors lost their directorships, their options would not vest.²³³ Millions of dollars, in the pockets of the so-called independent directors, were at stake.²³⁴

These cases demonstrate that the Delaware courts are willing, in what they believe to be appropriate circumstances, to dive deeply into surrounding circumstances when making decisions relevant to corporate directors' obligations. It seems fair to say that these cases may signal the direction of future rulings when questions of officer liability are directly presented. That is, if *Oracle* and *eBay* are representative, there seems to be a trend for courts to look beneath the surface of the issue presented and consider all the facts and

225. *Id.* at 930–35.

226. *Id.* at 942–47.

227. See Muir & Schipani, *supra* note 110, at 456–57, for further details concerning these relationships.

228. No. 19988-NC, 2004 Del. Ch. LEXIS 4, at *6–10 (Del. Ch. Feb. 11, 2004).

229. *Id.* at *11.

230. *Id.*

231. *Id.* at *9.

232. *Id.*

233. *Id.* at *11.

234. *Id.*

circumstances surrounding the issue.²³⁵ Such an approach is consistent with correlating liability with responsibility.

IV. CORRELATING CORPORATE OFFICER RESPONSIBILITY AND LIABILITY

Federal and state regulatory regimes have shown increased interest in defining the obligations of corporate officers. In Part II, we analyzed ERISA's approach to correlating fiduciary obligation with liability in benefit plans. In our examination of corporate law in Part III, we identified three opportunities for correlating officer duty of care obligations with potential personal liability. In this Part, we consider whether corporate law is likely to confront issues similar to those that have arisen under ERISA. We also examine whether ERISA's approach to the issues offers any guidance to state courts as they increasingly consider the fiduciary obligation of corporate officers. We begin with the problem of how to identify the specific corporate officers who should face potential liability for particular actions. We next turn to the role expertise should play in evaluating duty of care obligations. Then we discuss the applicability of the business judgment rule to decisions made by corporate officers. Finally, we address the challenges posed by conflicts of interest.

A. *Identification of Responsible Corporate Officers*

In direct comparison with state corporate law, ERISA's creation of functional fiduciaries and its limited use of formally appointed fiduciaries might first appear to produce significant gaps in responsibility. This would seem especially to be true when compared to corporate law's view that all officers are fiduciaries. The lesson from ERISA, though, is that when considering the efficacy of fiduciary regulation, one must consider both the definition of fiduciary status and the way in which that status is linked to a particular wrongful act. By defining fiduciary status

235. See *Beam v. Stewart*, 845 A.2d 1040, 1052 (Del. 2004) (discussing allegations necessary to "create a reasonable doubt about an outside director's independence"); *In re Compucom Sys., Inc. Stockholders Litig.*, No. Civ. A. 499-N, 2005 WL 2481325, at *9 (Del. Ch. Sept. 29, 2005) ("The court recognizes that under certain circumstances, professional, financial, and personal relationships of directors may preclude a finding of independence."); see also Lisa M. Fairfax, *Sarbanes-Oxley, Corporate Federalism, and the Declining Significance of Federal Reforms on State Director Independence Standards*, 31 OHIO N.U. L. REV. 381, 403-04 (2005) (discussing *Oracle* and *Stewart*, and arguing that the Delaware Supreme Court's decision in *Stewart* retreated from giving significant weight to personal relationships when determining the independence of the directors).

based on actions, ERISA establishes a natural link between the action and the fiduciary standard governing the action.²³⁶

Consider the hypothetical situation of a defined contribution plan where the plan committee determines the investment of plan assets. Because discretionary actions involving plan assets are deemed to be fiduciary actions, each of the committee members would be an ERISA fiduciary with a duty of care for the investment decisions. That remains true regardless of whether the committee consists of company officers, executives, or lower-level employees.

This approach directly links the fiduciary action of making asset investment decisions with the duty of care for those decisions. It also insulates both higher- and lower-level actors from direct responsibility for those decisions. Some higher-ranking executives, officers, and directors would have fiduciary responsibility to oversee the appointment of committee members and to monitor their actions. This is true even though the benefit plan itself would have been adopted by the directors because they would be permitted to delegate ongoing administration and investment issues to the plan committee. Other actors, regardless of their level, who may have input into the investment decisions in such ways as developing investment alternatives and executing committee decisions, would be insulated from fiduciary status and potential personal liability because, without discretion, those actors would not be ERISA fiduciaries. Actors, again regardless of their level, whose responsibilities do not touch on plan investment decisions have no fiduciary responsibility for those decisions, even if they are ERISA plan fiduciaries for other decisions, such as determinations of benefit eligibility.

The point of failure in the foregoing ERISA analysis occurs if the plan appoints the committee as the named fiduciary and an entity analysis is used to determine fiduciary status and possible liability. In that instance, the committee as an entity would be responsible for meeting the duty of care, but the individuals would be absolved of responsibility and potential personal liability. If, on the other hand, the derivative approach is used, the individual committee members remain liable.

The corporate principle that every officer has fiduciary obligations does not so neatly correlate responsibility with liability. Nor are the concerns of individual liability limited to the types of financial fraud seen in some of the recent corporate scandals. Consider the situation where a corporate officer, the Vice President of Product Development, negligently ignores signals that there is a safety issue in a new product. The Vice President of Manufacturing

236. 29 U.S.C. § 1102(a)(2) (2000).

may have sufficient experience to recognize that the product, if produced according to specifications, could result in the death or serious injury of customers. Perhaps the Vice President of Sales is aware that a competitor's past product had similar flaws. The Vice President of Facilities may have no logical reason at all to know of the potential safety problem, but actually is aware of it because he has friends in the Product Development department who are concerned about the issue. The CFO may be so consumed with ensuring that the company's financials meet accounting and securities standards that she has no knowledge of any of the details of the new product, let alone any awareness that it poses a potential safety hazard.

The product safety issue differs from the benefit plans hypothetical in that ERISA's principle of discretion relatively clearly circumscribes the benefit plan-related actions that create fiduciary status and responsibility. By basing its definition of fiduciary status on authority or discretionary actions, ERISA exempts numerous actions that touch upon benefit plans from fiduciary regulation even though those actions pertain to plan management and asset-related decisions.

At the same time, it ensures that fiduciaries only bear responsibility for the actions that create their fiduciary status. Corporate law does not similarly cabin fiduciary status though. Every corporate officer is a fiduciary and is obligated by the duty of care. Thus, corporate law currently offers no clear principles for determining which of the officers in the product safety hypothetical should face potential liability for breach of the duty of care.

ERISA's principle of linking fiduciary responsibility to specific actors by concentrating on the existence of discretion may have some power if imported to the corporate law arena. As evidenced in the example of investment decisions, under the ERISA approach, individuals who do not have decision-making authority or responsibility over plan assets are not fiduciaries for the investment decisions. That remains true even if their responsibilities touch upon plan investment decisions.

In the product safety situation, one might use discretion as the touch point to identify those officers who have sufficient discretion over product development to be responsible for remedial action. That principle would implicate the Vice President of Product Development, who clearly has discretion over the development of the new product. The principle would also seem to protect a CFO who typically has no discretion over product development. Given that the CFO also does not have any knowledge of the safety problem and there is no indication of any reason she should have been aware of the problem, there is no logical reason to evaluate her

accountability for a duty of care violation.

This approach also fits neatly with importation of agency law in defining the scope of an officer's fiduciary duty. As mentioned above, an officer may be defined as an agent appointed by the board with the power to exercise discretion and judgment. In the exercise of that discretion, the duty of care, as described in the Model Business Corporation Act, requires the exercise of "the care that a person in a like position would reasonably exercise under similar circumstances."²³⁷

The potential insights from ERISA's discretionary principle may end there, though. It is difficult to extrapolate the discretionary principle to the nuances of the corporate officer suite. Should an officer who has the expertise to identify a lapse in product safety be possibly liable for a breach of the duty of care by failing to observe the lapse, even if that officer does not play an active role in the product's development? Should an officer who has knowledge about the product safety problem, but whose job duties do not include discretion over product development, have an obligation to ensure the problem is addressed? If corporate law is to take seriously the duty of care of corporate officers and yet correlate the liability resulting from breach of that duty with responsibility, it will need to derive new principles to resolve those questions.

B. The Role of Expertise

Both ERISA and corporate law have struggled with the extent to which the expertise of a fiduciary should affect the standard applied to evaluate compliance with the duty of care. The courts disagree over the use of a prudent expert standard in ERISA. Rather than concentrate on the individual expertise of each fiduciary, however, the better approach in the ERISA context is reflected in the more general contextual approach that recognizes the importance of the plan sophistication, size, and other factors.

Again consider the hypothetical committee charged with investing plan assets. A fiduciary on that committee may have sufficient financial acumen to perfectly correlate the plan's investment in financial vehicles of various durations with the expected maturation of the plan's benefit payment obligations. For a small defined benefit plan, however, the expense in making and overseeing such complex investments, including the cost of properly compensating a plan fiduciary with such expertise, may grossly exceed the gains from such an investment strategy. If, however, the duty of care analysis takes into account the investment expertise of

237. MODEL BUS. CORP. ACT ANN. § 8.42(a)(2) (3d ed. Supp. 2005).

a fiduciary charged with discretion over plan assets, the fiduciary arguably may be required to utilize that investment expertise.

Perhaps the expert fiduciary could consider the costs and benefits of such an investment strategy and reject it on that basis. Requiring such an analysis by each plan fiduciary, however, would add unnecessary complexity to the analysis. The more elegant solution is to establish the scope of the duty of care based on the context of a small defined benefit plan. The result incorporates the traditional flexibility of fiduciary obligation while avoiding the detailed individualized determinations associated with a standard that requires evaluating the credentials of each plan fiduciary.

This contextual approach may also be instructive in establishing the appropriate standard of care for corporate officers. As discussed above, it seems likely that it could become more difficult to attract directors and officers with specific expertise if that expertise results in a higher standard of care. But officers, even more than directors, may be hired and compensated because of their experience and expertise. The full-time commitment of an officer also is a point of differentiation between officers and directors.

Particularly as applied to officers, corporate law might benefit by establishing the duty of care based on the context of responsibilities. Individual expertise would enter the analysis if relevant to the context. Thus, if individual officers are being hired and paid to use their expertise, then expertise would be important to the duty of care determination. This is consistent with the agency law duty which specifically calls for consideration of special skills and expertise.²³⁸ It would be important to not encourage executive officers to turn a blind eye toward issues they are hired to address. Conversely, the contextual approach would avoid the over burdensome outcome of imposing an obligation to use expertise in an area outside of an individual officer's assigned responsibilities.

C. The Applicability of the Business Judgment Rule

Interesting parallels, as well as some important differences, exist between the business judgment rule and the deferential standards ERISA utilizes to protect plan fiduciaries. The business judgment rule applies to decisions of the board of directors so long as the decision meets the basic requirements of the rule. Although specific factors, such as the existence of a conflict of interest, are relevant in deciding whether to apply the rule, in general, the type of decision being evaluated does not impose a threshold for

238. RESTATEMENT (THIRD) OF AGENCY § 8.08 (2006).

application of the business judgment rule.²³⁹ Also, there is a debate over whether it is a rule, a doctrine, or a standard of care.²⁴⁰ In contrast, ERISA's deferential standards are context-specific. In this Article, we considered two of those deferential standards—the presumption in favor of ESOP investments in company stock and the use of the arbitrary and capricious standard of review for determinations of plan benefit eligibility. The ERISA approach clearly is to utilize deferential standards of review rather than modifications to the fiduciary duty of care.

The theoretical justifications, including avoidance of second-guessing and risk aversion,²⁴¹ that support the use of the business judgment rule to evaluate board decisions also apply in the ERISA context. The concern that failure to apply a deferential standard of review to officer decisions would nullify the protection given to boards that delegate decision making has particular resonance with the ERISA experience. In the context of decisions regarding benefit eligibility, a key determinant of whether a deferential review standard will be used is whether the benefit plan grants interpretative discretion to the fiduciary. Corporate officers have the responsibility to put into effect the strategic plans and policies formulated by the board of directors. An ERISA fiduciary charged with determining benefit eligibility has the responsibility to ensure that benefit plan participants receive the benefits contemplated by the plan sponsor, but only those benefits.

Consider again the example of the product safety issue. Assume the Vice President of Product Development does nothing, the product goes to market unchanged, and customers are seriously injured. As a result, the corporation suffers loss of market share, incurs substantial legal costs, and its stock price declines. In a world increasingly focused on the responsibilities of corporate officers, shareholders may ask whether the VP breached his duty of care.

In our initial analysis, we argued that a focus on discretion would justify applying the duty of care regarding safety in the product development process to the VP of Product Development. At minimum, the VP would be expected to use the expertise appropriate given the context of the company and its product

239. Here we are considering ordinary business decisions, or the “traditional business judgment rule,” as defined by Bainbridge. BAINBRIDGE, *supra* note 159, at 284. Bainbridge notes, however, two variants of the rule—one applied in the sale of business and the other which he calls a “conditional” business judgment rule in the context of takeover defenses. *Id.*

240. *See supra* notes 159–62 and accompanying text.

241. *See supra* notes 165–207 and accompanying text.

development function. Again we assume the VP negligently permitted the product to go forward. The question we now confront is whether that VP's decisions regarding the product should be entitled to the presumption of the business judgment rule or some other deferential standard of review.

The need to avoid second-guessing and lawsuits based on hindsight knowledge certainly has application to the decisions of corporate officers. The nature of officers' duties is to oversee day-to-day implementation of corporate strategy. That requires continuous decision making and exercise of business judgment. One can easily imagine the extent of litigation that would exist in the absence of any legal principle providing at least a minimal level of protection to some decisions made by officers. The lesson from ERISA, though, is that conflicts of interest pose a serious challenge to formulating and implementing deferential review standards.

D. The Challenge of Conflicts of Interest

Before drawing together the ERISA and corporate analyses on conflicts of interest, it is useful to review the traditional trust law standard that applies to situations involving a conflict of interest. Historically, that standard has been a harsh one, so that if a fiduciary acts in a transaction in which her personal interest conflicts with the trust beneficiary's interest, the transaction is conclusively presumed to be invalid.²⁴² Exceptions exist to permit specific categories of interest transactions, and the harshness of the standard has garnered some criticism.²⁴³ However, trust law's presumption against an interested fiduciary is a strong one.

In contrast, as noted above, ERISA explicitly allows agents of plan sponsors and of other fiduciaries to act as ERISA fiduciaries.²⁴⁴ Thus, the acceptance of conflicted fiduciaries is in tension with ERISA's fiduciary obligation of loyalty. The extent of the structural problem created by ERISA is evidenced in the continuing difficulties confronted by courts in reviewing benefit eligibility determinations.

Whether the decision regarding benefit eligibility is made by an insurer or the plan sponsor, the approval of a benefit entitlement typically is directly contrary to the financial interests of the fiduciary charged with making the determination. An insurer who denies benefits has lower costs than one that approves benefits. A plan that pays benefits costs more to sponsor than one that denies benefits. The courts continue to struggle with how such an

242. John H. Langbein, *Questioning the Trust Law Duty of Loyalty: Sole Interest or Best Interest?*, 114 *YALE L.J.* 929, 931 (2005).

243. *Id.* at 963-80.

244. *See supra* note 96 and accompanying text.

intractable conflict should affect application of the deferential standard of review.²⁴⁵

In our previous work, we analyzed the need for protection of ERISA fiduciaries when those fiduciaries make decisions that affect investments in company-sponsored investment plans, such as 401(k) plans.²⁴⁶ There we advocated the use of a two-tiered review approach. Where the decisions do not involve employer stock or other serious conflicts, we believe the appropriate standard to be “an objective standard requiring [the fiduciary] (1) to employ proper methods to investigate, evaluate and structure the investment; (2) to act in a manner as would others who have a capacity and familiarity with such matters; and (3) to exercise independent judgment when making investment decisions.”²⁴⁷ Where intractable conflicts of interest inhere in the fiduciary decision, we call for the use of stricter review.²⁴⁸

If the business judgment rule is extended to the decisions of corporate officers, it will need to account for similar structural conflicts of interest. In the context of board decisions, corporate law’s application of the business judgment rule has developed mechanisms to account for the conflicts of interest that sometimes exist. Boards must form committees of independent directors to make some types of decisions. The business judgment rule is applied with special severity when the board is making a decision on a hostile tender offer. When the decision maker is a corporate officer, though, conflicts may be more frequent, less easily avoided through independent reviews, and more structurally ingrained.

To the extent serious conflicts of interest are present, it would seem that the presumption of the business judgment rule should not apply. As discussed above, at the board level, the business judgment rule presumptions generally only come into play when courts are not concerned about conflicts of interest, breach of the duty of loyalty, or intentional misconduct. To the extent any of these issues might impair the judgment of officers, scrutiny of the business decision itself, rather than simply the process, would seem to be warranted. Based both on the experience in ERISA and the challenges confronted over the years by courts in the context of board decisions, we expect that courts will struggle to identify when officer conflicts of interest are sufficiently severe to give concern as

245. See *supra* notes 88–103 and accompanying text for a discussion of the standard of review and the controversy.

246. Muir & Schipani, *supra* note 89, at 354–56.

247. *Id.* at 355 (quoting *Ulico Cas. Co. v. Clover Capital Mgmt., Inc.*, 335 F. Supp. 2d 335, 340 (N.D.N.Y. 2004)).

248. *Id.* at 356.

state corporate law attempts to correlate officer fiduciary responsibility with liability. Similarly, we expect, again based on the ERISA experience and the analysis used for corporate boards, that courts will need to use a contextual approach to determine the effect conflicts of interest should have on the review of corporate officer actions.

V. CONCLUSION

We agree with other commentators that the fiduciary duty of officers is not well developed in corporate law.²⁴⁹ The current trend seems to be in the direction of imposing liability commensurate with responsibility. The scandals of the late 1990s and early 2000s, the enactment of SOX²⁵⁰ in response thereto, and a new wave of corporate scandals involving backdating of stock options make it clear that upper management misconduct is in the spotlight.

In response, state law seems to be ratcheting up the scrutiny of corporate behavior. There is precedent dating back to the financial failures of the 1930s for turning up the heat in the wake of financial scandals.²⁵¹ Today, we see the duty of loyalty and good faith imposing a heavier burden on a director who, due to his expertise under the circumstances, should have known better than to let the fraud occur.²⁵² We also see the Delaware courts highly scrutinizing personal and business relationships as they relate to the ability of a board member to render impartial judgments.²⁵³ It would not be much of a stretch for courts to further scrutinize the role of officers in light of their obligations to the corporation.

As the corporate law courts further define the scope of fiduciary duties in the executive suite, the experience of the courts in implementing ERISA's fiduciary standards serves as both a guide and as a warning. ERISA has linked liability with the acts of responsible fiduciaries by using the touchstone of discretion.²⁵⁴ Similarly, discretionary authority and responsibility can serve as a principle to determine which corporate officers should be subjected to scrutiny for particular wrongdoing.²⁵⁵ Second, in determining whether an ERISA fiduciary has breached the standard of care, the courts have had to consider the role expertise should play in the

249. *See supra* notes 129–31 and accompanying text.

250. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2003) (codified as amended in scattered sections of 11, 15, 18, 28, and 29 U.S.C.).

251. *See supra* notes 208–22 and accompanying text.

252. *See supra* notes 199–205 and accompanying text.

253. *See supra* notes 223–35 and accompanying text.

254. *See supra* notes 17–21 and accompanying text.

255. *See supra* Part IV.A.

analysis.²⁵⁶ Although this remains unsettled, we believe that the proper approach is to take into account the nature of the benefit plan at issue and the level of sophistication of investments. Agency law envisions holding agents to the standard of care of the reasonable person acting in similar circumstances, taking into account special expertise.²⁵⁷ We argue that these considerations call for application of a similar, contextual approach to the role of expertise in determining the standard of care applied to corporate officers.

Increasing emphasis on linking corporate officer fiduciary responsibility and liability has created a controversy over whether the business judgment rule should apply to decisions made by corporate officers. Here too, ERISA has confronted a similar issue in reviewing the decisions made by plan fiduciaries. The ERISA experience leads us to predict that when fiduciaries act in good faith and in an informed manner, the primary problem the courts will confront is how to identify and account for conflicts of interest.

We believe it is likely that the future will bring forth opportunities for the courts to further define the fiduciary duty of care as it applies to corporate officers. ERISA's experience in correlating liability with fiduciary responsibility teaches that the effort is not without serious challenges. That experience is also helpful in predicting the issues courts will face as they consider the scope of fiduciary responsibility of corporate officers. Although ERISA's approaches to resolving the issues in correlating liability with responsibility are far from simple or fully developed, they do envision a high standard of care coupled with flexibility to consider specific facts and circumstances. We recommend a similarly contextual-based approach to the courts as they confront similar issues in holding corporate officers responsible for their actions.

256. *See supra* Part IV.B.

257. *See supra* notes 151–54 and accompanying text.