
The (Un)Enforcement of Corporate Officers' Duties

Megan W. Shaner*

Over the past few decades, officers have arguably become some of the most important individuals in the corporation. From the implosions of Enron and WorldCom, to the success of companies like Apple and Microsoft, to the Wall Street crisis that sunk the world into near global recession, corporate officers have played a role in each of these storylines and countless (albeit lesser known) others. In spite of the well-publicized scandals, officers continue to be given wide latitude to carry out their role of managing the day-to-day operations of their companies. The primary constraint on this power under state corporate law is the imposition of fiduciary obligations. Fiduciary duties thus play a vital role in checking the considerable power and authority of officers. Fiduciary duties will only affect officer behavior, however, if there is an effective enforcement scheme that holds officers accountable. This Article discusses how the development of corporate doctrine, coupled with the dynamic in today's corporate management has created impediments and disincentives for the enforcement of officer fiduciary duties. In light of the problematic state of the current enforcement scheme, this Article evaluates possible changes that would alleviate deterrents in the enforcement process. This Article concludes that in order to regulate officer behavior with fiduciary duties, there must be a collective correction to the enforcement mechanisms in place for internal enforcers beginning with reevaluating stockholder derivative litigation burdens.

* Copyright © 2014 Megan W. Shaner. Associate Professor of Law, University of Oklahoma College of Law. This paper was awarded first prize out of a blind review of approximately 80 submitted papers at the Center for Law, Economics and Finance (C-LEAF) Junior Faculty Workshop at George Washington University Law School. For helpful comments and discussions I would like to thank Steven Davidoff Solomon, Lisa M. Fairfax, Sean J. Griffith, Lawrence A. Hamermesh, Joan M. Heminway, Claire A. Hill, Lyman P.Q. Johnson, and Robert T. Miller. I would also like to thank the participants in the Florida State Junior Faculty Workshop, SEALS Junior Scholars Colloquia, and C-LEAF Junior Faculty Workshop whose thoughtful comments and questions contributed to the completion of this paper.

TABLE OF CONTENTS

INTRODUCTION	273
I. THE CORPORATE OFFICER	285
A. <i>The Role of Officers</i>	285
B. <i>Officer Misconduct</i>	289
II. FIDUCIARY DUTIES OF OFFICERS	294
A. <i>The Nature of Fiduciary Duties</i>	294
B. <i>Officer Fiduciary Duties</i>	296
III. ENFORCEMENT OF OFFICER FIDUCIARY DUTIES	299
A. <i>Why Focus On Enforcement</i>	300
B. <i>Corporate Actors That Enforce Officer Fiduciary Duties</i>	303
1. Board of Directors	304
2. Stockholders	311
3. Creditors	319
IV. STRENGTHENING ENFORCEMENT	321
A. <i>Focusing on Stockholders</i>	324
B. <i>Reevaluating Derivative Litigation Burdens</i>	325
1. <i>The Demand Excused Requirement</i>	329
2. <i>The Role of Special Litigation Committees</i>	331
CONCLUSION	335

INTRODUCTION

A strong argument can be made that the officer¹ is one of the most influential yet frequently overlooked individuals in the corporate enterprise. While the board of directors, statutorily tasked with ultimate management responsibility, has been described as “the focal point of the corporate governance system,”² it is not the only corporate actor that can (and does) have a significant impact on a corporation. Boards are allowed to delegate much of their management authority and the most common recipient is the corporate officer.³ Accordingly, officers can, and often do, play an integral role in corporate decision-making and governance. Over the years, this delegation has led to the predominant model of corporate governance in the United States being an officer-dominated one, with boards of directors, stockholders, subordinate officers, and outside advisors deferring to senior executive officers.⁴

¹ For purposes of this Article, the term “corporate officer” or “officer” refers to non-director officers or persons who serve as both a director and an officer in the corporation but are acting in their officer capacity. Within this group, this Article focuses primarily on senior/executive officers.

² Standards Relating to Listed Company Audit Committees, Exchange Act Release No. 33-8220, 68 Fed. Reg. 18,788, 18,789 (Apr. 16, 2003) (to be codified at 17 C.F.R. pts. 228, 229, 240, 249, 274), available at <http://www.gpo.gov/fdsys/pkg/FR-2003-04-16/pdf/03-9157.pdf>; see also Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547, 559-60, 605-06 (2003) [hereinafter *The Means and Ends*]; Stephen M. Bainbridge, *Director Primacy and Shareholder Disempowerment*, 119 HARV. L. REV. 1735, 1735-36 (2006) [hereinafter *Shareholder Disempowerment*].

³ See DEL. CODE ANN. tit. 8, §§ 141(a), 142 (2014); *Grimes v. Donald*, No. CIV.A.13358, 1995 WL 54441, at *8-9 (Del. Ch. Jan. 11, 1995), *aff'd*, 673 A.2d 1207 (Del. 1996); EDWARD P. WELCH, ET AL., *FOLK ON THE DELAWARE GENERAL CORPORATION LAW*, §141.1.2 at GCL-IV-20 (5th ed. 2013) (“The details of the business may be delegated to officers, agents, and employees.”). There are, however certain responsibilities that the board may not delegate. See, e.g., DEL. CODE ANN. tit. 8, § 251(a) (2014) (requiring the board approve a merger agreement); *id.* § 242(b)(1) (2014) (requiring the board approve amendments to the certificate of incorporation). In addition, the board cannot abdicate its management responsibilities. See *Grimes*, 1995 WL 54441, at *9.

⁴ See Lyman Johnson & Robert Ricca, *Reality Check on Officer Liability*, 67 BUS. LAW. 75, 82 (2011) [hereinafter *Reality Check*] (“Of the three main actors in corporate governance (shareholders, directors, and officers), the officers clearly continue to reign supreme.”); Tom C.W. Lin, *The Corporate Governance of Iconic Executives*, 87 NOTRE DAME L. REV. 351, 363-65 (2011) (describing how iconic executives capture much of the deference from directors, officers, outside advisors and gatekeepers); Troy A. Paredes, *Too Much Pay, Too Much Deference: Behavioral Corporate Finance, CEOs, and Corporate Governance*, 32 FLA. ST. U. L. REV. 673, 673 (2005) [hereinafter *Too Much Pay*] (noting the “extensive corporate control concentrated in [CEOs’] hands and the fact that they are rarely seriously challenged”); Usha Rodrigues, *From Loyalty to Conflict:*

Given the central role that officers play today in managing the business of the corporation, it should not be surprising that recent instances of corporate malfeasance can be subscribed, at least in part, to the actions of corporate management outside the board of directors.⁵ Former Chief Justice Veasey of the Delaware Supreme Court, for instance, has described instances of corporate fraud in the early twenty-first century as including: “(1) officers [running] amok, wallowing in greed-driven schemes and other abuses; and (2) directors allow[ing] it to happen, tolerating officers who were managing to the market while they contented the directors with ever-rising stock prices.”⁶ Indeed, what has been repeatedly noted following each corporate scandal are instances of corporate officers putting their own personal interests ahead of the corporation’s and its stockholders.⁷ The recent frequency with which officers have been found to have acted in a self-interested manner has led to “widespread disenchantment with the behavior of many corporate executives, both within and outside the corporate world.”⁸ Moreover, as summarized by one corporate commentator, “the core problem faced by investors today, as revealed by corporate scandals, is that investors must be better protected from [officers].”⁹

Instances of corporate misconduct typically prompt extensive debate and discussion regarding corporate governance reform.¹⁰ As part of this

Addressing Fiduciary Duty at the Officer Level, 61 FLA. L. REV. 1, 1, 6 (2009) (describing corporate officers as the “true corporate decisions makers” and the “powerbrokers of the corporation”).

⁵ See *infra* Part I.B; see also Kathleen F. Brickey, *From Enron to WorldCom and Beyond: Life and Crime After Sarbanes-Oxley*, 81 WASH. U. L.Q. 357, 358 (2003) (“To date, some ninety corporate owners, executives, and employees have been criminally charged, and the investigations are ongoing.”); Joseph E. Murphy, *Can the Scandals Teach Us Anything? Enron, Ethics and Lessons for Lawyers*, BUS. L. TODAY, Jan.–Feb. 2003, at 10, 11 (stating that in each of the breakdowns in 2001–2002 it was not rogue employees who were primarily at fault, rather high-profile corporate executives); *Executives on Trial: Scandal Scorecard*, WALL ST. J., Oct. 3, 2003, at B1 (detailing criminal charges and investigations involving corporate officers).

⁶ E. Norman Veasey, *State-Federal Tension in Corporate Governance and the Professional Responsibilities of Advisors*, 28 J. CORP. L. 441, 441-42 (2003).

⁷ See Paredes, *Too Much Pay*, *supra* note 4, at 680; Rodrigues, *supra* note 4, at 3 (“Even as the Enron and WorldCom frauds gave way to fresher tales of options backdating, corporate looting, insider trading, and more recently out-sized golden parachutes, the common denominator remained the fact that corporate agents put their own interests above those of the corporation.”).

⁸ See Johnson & Ricca, *Reality Check*, *supra* note 4, at 93.

⁹ See D. QUINN MILLS, *WHEEL, DEAL, AND STEAL: DECEPTIVE ACCOUNTING, DECEITFUL CEOs, AND INEFFECTIVE REFORMS* 183 (2003).

¹⁰ See *Report of the Task Force of the ABA Section of Business Law Corporate Governance Committee on Delineation of Governance Roles and Responsibilities*, 65 BUS.

larger discussion, the role of the board of directors has garnered a significant amount of attention.¹¹ The overwhelming focus on the board

LAW. 107, 145-46 (2009) [hereinafter *ABA Report*] (“Renewed concern that our society is deeply dependent on the continued health and viability of corporations for economic growth has heightened the scrutiny of current corporate governance practices.”).

These discussions have taken place among members of the bench, bar, academia, and federal government. See, e.g., Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §§ 951, 971, 972, 124 Stat. 1376, 1899, 1915 (2010) [hereinafter Dodd-Frank] (codified at 15 U.S.C. § 78n) (addressing executive compensation, proxy access and disclosure of chairman and CEO structures); Sarbanes-Oxley Act, Pub. L. No. 107-204, §§ 202, 301, 302, 402, 906, 116 Stat. 745, 772, 775, 777, 787, 806 (2002) (codified at 15 U.S.C. §§ 78f, 78j-78m, 78o and 18 U.S.C. § 1350) (addressing auditors, audit committees, officer certification, prohibition on loans to officers and financial reports); STEPHEN M. BAINBRIDGE, CORPORATE GOVERNANCE AFTER THE FINANCIAL CRISIS (2012) (discussing corporate governance following the financial crisis); *ABA Report, supra*, at 107 (noting that the decisions, rights, and responsibilities of directors and stockholders are shifting especially following the financial crisis); John C. Coffee, Jr., *Understanding Enron: “It’s About the Gatekeepers, Stupid,”* 57 BUS. LAW. 1403, 1403-05 (2002) [hereinafter *Understanding Enron*] (discussing the failure of gatekeepers in corporate governance); Lynne L. Dallas, *Short-Termism, The Financial Crisis, and Corporate Governance*, 37 J. CORP. L. 265, 267-68 (2012) (discussing how short-termism by managers, investors, and others contributed to the financial crisis); Jeffrey N. Gordon, *What Enron Means for the Management and Control of the Modern Business Corporation: Some Initial Reflections*, 69 U. CHI. L. REV. 1233, 1233-35 (2002) (discussing problems for corporate governance that Enron raised); Robert W. Hamilton, *The Crisis in Corporate Governance: 2002 Style*, 40 HOUS. L. REV. 1, 3-4 (2003) [hereinafter *2002 Style*] (discussing events relating to corporate governance during 2001-2002); *Preliminary Report of the American Bar Association Task Force on Corporate Responsibility*, 58 BUS. LAW. 189, 189 (2002) (examining issues related to corporate responsibility and governance arising out of Enron and similar situations); Leo E. Strine, Jr., *Breaking the Corporate Governance Logjam in Washington: Some Constructive Thoughts on a Responsible Path Forward*, 63 BUS. LAW. 1079, 1079 (2008) (discussing the proxy access and say on pay initiatives); Veasey, *supra* note 6, at 441-42 (discussing corporate governance and ethics reforms after Enron); William H. Donaldson, Chairman, U.S. Sec. & Exch. Comm’n, Remarks at the 2003 Washington Economic Policy Conference (Mar. 24, 2003) [hereinafter Remarks of Chairman William H. Donaldson], available at <http://www.sec.gov/news/speech/spch032403whd.htm> (speaking on corporate governance practices); Timothy F. Geithner, Sec’y, U.S. Dep’t of Treasury, Statement Before the Committee on Financial Services U.S. House of Representatives (Mar. 26, 2009), available at <http://democrats.financialservices.house.gov/media/file/hearings/111/geithner032609.pdf> (discussing financial regulatory reform); Alan Greenspan, Chairman, Fed. Reserve Bd., Federal Reserve Board’s Semiannual Monetary Policy Report to the Congress, Testimony Before the Committee on Banking, Housing, and Urban Affairs (July 16, 2002) [hereinafter Testimony of Chairman Alan Greenspan], available at <http://www.federalreserve.gov/boarddocs/hh/2002/july/testimony.htm> (speaking on the corporate scandals of 2001–2002).

¹¹ See *ABA Report, supra* note 10, at 133 (noting that following the financial crisis, the “[c]urrent political and regulatory focus is on the board, and adjustments to governance regulation are more than likely in response”).

is to be expected, but perhaps it is somewhat misplaced. Despite officers' key roles in modern corporate governance, there has been surprisingly limited specific attention given to the officer as an individual corporate actor. Officer fiduciary duties, in particular, are underdeveloped and relatively unenforced, yet officer misconduct has been inextricably linked to most corporate scandals.¹² This Article posits that the lack of focus on officers is attributable in part to, and is further exacerbated by, the current enforcement scheme for officer fiduciary duties. In fact, many of the enforcement mechanisms available actually discourage those who should be able to hold officers accountable for their actions from doing so.

Scholars, legislators, and jurists have struggled with and disagreed over how best to deal with the corporate officer, including officers' proper management roles and accountability concerns. One example is the debate amongst scholars regarding the appropriate classification of officers (i.e., as agents, non-agent director-like fiduciaries, or corporate organs) and, relatedly, the content of officers' fiduciary duties and corresponding standards of liability.¹³ In addition, there is disagreement over whether the protections of the business judgment rule should be afforded to directors and officers alike.¹⁴ Even the courts, in discussing

Views on how to best correct the problems in corporate governance and prevent future scandals via the board of directors range from addressing the composition of the board and its committees to suggesting the elimination of the board altogether. *See, e.g.*, Dodd-Frank § 952 (requiring independent directors on the compensation committee); Sarbanes-Oxley Act § 301 (codified in scattered sections of 11 U.S.C., 15 U.S.C., 18 U.S.C., 28 U.S.C., and 29 U.S.C.) (requiring independent directors on the audit committee); Kelli A. Alces, *Beyond the Board of Directors*, 46 WAKE FOREST L. REV. 783, 805-07 (2011) (suggesting abolishing a formal board of directors).

¹² *See infra* Part I.B.

¹³ *See* Megan W. Shaner, *Restoring the Balance of Power in Corporate Management: Enforcing an Officer's Duty of Obedience*, 66 BUS. LAW. 27, 36-43 (2010) [hereinafter *Restoring the Balance*] (summarizing the debate over officer fiduciary duties). *Compare* A. Gilchrist Sparks, III & Lawrence A. Hamermesh, *Common Law Duties of Non-Director Corporate Officers*, 48 BUS. LAW. 215 (1992) (taking the position that officers' fiduciary duties are the same as directors'), with Amitai Aviram, *Officers' Fiduciary Duties and the Nature of Corporate Organs*, 2013 ILL. L. REV. 763 (asserting that officers should be divided into corporate organs or corporate agents and that accountability should then flow from such classification), and Lyman P.Q. Johnson & David Millon, *Recalling Why Corporate Officers Are Fiduciaries*, 46 WM. & MARY L. REV. 1597 (2005) (taking the position that agency law fiduciary principles are the basis for officers' fiduciary duties).

¹⁴ *See* Paul Graf, *A Realistic Approach to Officer Liability*, 66 BUS. LAW. 315, 328-34 (2011). *Compare* Lyman P.Q. Johnson, *Corporate Officers and the Business Judgment Rule*, 60 BUS. LAW. 439 (2005) (arguing that the business judgment rule does not apply to officers), with Lawrence A. Hamermesh & A. Gilchrist Sparks, III, *Corporate Officers and the Business Judgment Rule: A Reply to Professor Johnson*, 60 BUS. LAW. 865 (2005)

fiduciary duty issues, have historically lumped officers and directors together, with little attention given to individuals vis-à-vis their roles as officers.¹⁵

As these examples illustrate, existing problems in corporate management, including those engaging the role of officers, raise broad questions that can be approached in a myriad of ways.¹⁶ This Article looks at just one piece of this much larger puzzle: restraining officer behavior with traditional fiduciary duties under state corporate law. Of course, fiduciary duties are only one of many different constraints on officer behavior.¹⁷ Nevertheless, it is important to focus on fiduciary

(asserting that the business judgment rule applies to officers).

¹⁵ See, e.g., *In re Walt Disney Co.*, No. CIV.A.15452, 2004 WL 2050138, at *3 (Del. Ch. Sept. 10, 2004) (“To date, the fiduciary duties of officers have been assumed to be identical to those of directors.”); *Copi of Del., Inc. v. Kelly*, No. CIV.A.14529, 1996 WL 633302, at *5 (Del. Ch. Oct. 25, 1996) (“Officers and directors of a corporation owe a fiduciary duty to shareholders.”); see also Johnson & Millon, *supra* note 13, at 1600 (“[C]ourts and commentators routinely describe the duties of directors and officers together, and in identical terms.”); Shaner, *Restoring the Balance*, *supra* note 13, at 31-34; Sparks & Hamermesh, *supra* note 13, at 215 (“The precise nature of the duties and liabilities of corporate officers who are not directors is a topic that has received little attention from courts and commentators.”).

¹⁶ For example, at the federal level, legislation such as Sarbanes-Oxley, Dodd-Frank, and the regulations promulgated by the SEC under those laws have attempted to address some of the problems perceived at the officer level. See Dodd-Frank §§ 951, 952 (providing for “say on pay” and “say when on pay” votes as well as independent compensation committees); Sarbanes-Oxley Act § 302 (requiring a public corporation’s chief executive officer and chief financial officer to certify financial reports filed under the federal securities laws). In addition, self-regulatory organizations such as NASDAQ adopted new regulations aimed at regulating corporate director and officer conduct. See Johnson & Millon, *supra* note 13, at 1615; Lyman P.Q. Johnson & Mark A. Sides, *The Sarbanes-Oxley Act and Fiduciary Duties*, 30 WM. MITCHELL L. REV. 1149, 1219-25 (2004); Hillary A. Sale, *Delaware’s Good Faith*, 89 CORNELL L. REV. 456, 456-57 (2004) [hereinafter *Delaware’s Good Faith*]. These legislative and regulatory efforts have, however, been criticized as ineffective in correcting the perceived problems in corporate governance. See, e.g., Jill E. Fisch, *Leave it to Delaware: Why Congress Should Stay Out of Corporate Governance*, 37 DEL. J. CORP. L. 731, 745 (2013) (discussing the “relative deficiencies of federal alternatives” and stating that “[a]lthough it is too early to evaluate Congress’ response under Dodd-Frank, the initial evidence is less than promising and reinforces commentators’ prior intuitions about the superiority of state regulation”); Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521, 1529-43, 1602 (2005) (evaluating the corporate governance mandates in Sarbanes-Oxley and finding that “extensive empirical literature suggests that those mandates were seriously misconceived, because they are not likely to improve audit quality or otherwise enhance firm performance and thereby benefit investors”).

¹⁷ Other constraints include: (i) federal statutes and regulations, see *supra* note 16 (describing federal regulation of corporations); (ii) the corporation’s organizational documents (i.e., the certificate of incorporation and bylaws), see DEL. CODE ANN. tit. 8,

obligations because under state corporate law norms, fiduciary duties are the primary constraint on the power given to both the directors and the officers of the corporation.¹⁸ Historically, corporations were subject

§ 142(a)–(b) (2014) (providing that selection, terms and duties of officers shall be stated in the bylaws or as determined by the board); *id.* § 102(b)(1) (2014) (providing that the certificate of incorporation may contain any provision permitted or required to be in the bylaws); (iii) the board of directors in selecting and delegating authority to officers (e.g., board resolutions), *see id.* § 142(a) (“Every corporation . . . shall have such officers with such titles and duties as shall be stated . . . in a resolution of the board of directors . . .”); (iv) self-regulatory organizations (e.g., NASDAQ), *see* Larry E. Ribstein, *Why Corporations?*, 1 BERKELEY BUS. L.J. 183, 218-19 (2004); (v) creditors, *see, e.g.*, Douglas G. Baird & Robert K. Rasmussen, *Private Debt and the Missing Lever of Corporate Governance*, 154 U. PA. L. REV. 1209 (2006) (discussing the growing role of creditors in corporate governance); (vi) D&O insurers, *see, e.g.*, Tom Baker & Sean J. Griffith, *The Missing Monitor in Corporate Governance: The Directors’ & Officers’ Liability Insurer*, 95 GEO. L.J. 1795, 1795-99 (2007) (reporting results of empirical research on D&O insurers’ monitoring role); James D. Cox, *Private Litigation and the Deterrence of Corporate Misconduct*, 60 LAW & CONTEMP. PROBS., Autumn 1997, at 1, 29-36 (discussing the discipline of the insurance market); (vii) employment agreements, *see, e.g.*, Johnson & Millon, *supra* note 13, at 1639-41 (discussing officer employment agreements); Daniel S. Kleinberger, AGENCY, PARTNERSHIPS, AND LLCs: EXAMPLES AND EXPLANATIONS 162 (4th ed. 2012) (stating that “an agent typically owes duties in contract as well as under agency law”); (viii) benefit plans, *see, e.g.*, Dana M. Muir & Cindy A. Schipani, *Fiduciary Constraints: Correlating Obligation With Liability*, 42 WAKE FOREST L. REV. 697, 698-715 (describing ERISA’s fiduciary standards); (ix) securities markets, *see, e.g.*, Sean J. Griffith, *Deal Protection Provisions in the Last Period of Play*, 71 FORDHAM L. REV. 1899, 1937 (2003) (noting the role of securities markets in influencing management); (x) the market for corporate control, *see, e.g., id.* (discussing the market for corporate control as a means of applying pressure on management); Eric J. Pan, *Rethinking the Board’s Duty to Monitor: A Critical Assessment of the Delaware Doctrine*, 38 FLA. ST. U. L. REV. 209, 218-19 (2011) [hereinafter *Rethinking the Board’s Duty to Monitor*] (noting the market for corporate control as an external source of pressure on managers); (xi) the employment market, *see, e.g.*, Renee M. Jones, *Law, Norms, and the Breakdown of the Board: Promoting Accountability in Corporate Governance*, 92 IOWA L. REV. 105, 116-17 (2006) (discussing the employment market for managers); Ralph K. Winter, Jr., *State Law, Shareholder Protection and the Theory of the Corporation*, 6 J. LEGAL STUD. 251, 262-73 (1977) (pointing out that the employment market and product market constrain management actions); and (xii) social norms, *see, e.g.*, Jones, *supra*, at 108 (discussing the role of social norms in regulating director conduct).

¹⁸ *See* Randy J. Holland, *Delaware Directors’ Fiduciary Duties: The Focus on Loyalty*, 11 U. PA. BUS. L. 675, 678 (2009) (stating that fiduciary duties “are an equitable response to the power that is conferred upon directors as a matter of statutory law”); Ribstein, *supra* note 17, at 198.

Secondarily, a reason to focus on fiduciary duties is the risk to state corporate law structures as a result of federal preemption. *See* Mark J. Roe, *Delaware’s Competition*, 117 HARV. L. REV. 588, 600 (2003); *see also* Stephen M. Bainbridge, *The Creeping Federalization of Corporate Law*, REG., Spring 2003, at 26, 31 (asserting that the “substance of corporate governance standards is appropriately left to the states” as opposed to the federal government). Where state law has been seen as leaving gaps or

to strict regulation by the states.¹⁹ As that mandatory regime of corporate law was relaxed to provide greater flexibility for managers to structure and run the business, what emerged was an enabling body of corporate law with “judicial review of the actions of corporate officers and directors, measured by fiduciary principles.”²⁰ Fiduciary duties thus set forth the standards of conduct that we expect of officers, although, as has been noted in the context of directors, the potential for liability is narrower than the standards of conduct to meet fiduciary obligations.²¹ Accordingly, fiduciary duties are the most central way of holding officers accountable under state corporate law.²²

The role of fiduciary duties in constraining officer behavior can be separated into several components, three of which are particularly

failing to adequately regulate, federal law has slowly been moving into the corporate law arena. With respect to corporate officers in particular, scholars have noted that certain aspects of each of Sarbanes-Oxley and Dodd-Frank address officer accountability, indicating that the federal government is willing to step in to directly regulate officer conduct to the extent that state corporate law fails to do so. See Donald E. Schwartz, *In Praise of Derivative Suits: A Commentary on the Paper of Professors Fischel and Bradley*, 71 CORNELL L. REV. 322, 342 (1986) (“Legislators cannot ignore the corporate accountability problem and they are unlikely to regard the marketplace as the only appropriate mechanism to constrain managers.”); Robert B. Thompson & Hillary A. Sale, *Securities Fraud as Corporate Governance: Reflections Upon Federalism*, 56 VAND. L. REV. 859, 886 (2003) (“State law actually says very little affirmatively about what officers are supposed to do (in contrast to the relatively well-developed roles of directors and shareholders). [Conversely,] Congress expressed its clear intent, through the Sarbanes-Oxley Act, to regulate the conduct of officers, in the context of the duties of care, loyalty, and good faith.”); see also CHARLES R. T. O’KELLEY & ROBERT B. THOMPSON, CORPORATIONS AND OTHER BUSINESS ASSOCIATIONS 155 (6th ed. 2010) (“More recently, federal law, as opposed to the laws of the 50 states that are the source of corporate law mentioned above, has begun to play a role in the specification of officers’ duties.”); Troy A. Paredes, Comm’r, U.S. Sec. & Exch. Comm’n, Statement at Open Meeting to Adopt the Final Rule Regarding Facilitating Shareholder Director Nominations (“Proxy Access”) (Aug. 25, 2010) [hereinafter Statement of Comm’r Troy Paredes], available at <http://www.sec.gov/news/speech/2010/spch082510tap.htm>. Accordingly, a focus on and strengthening of the role of fiduciary duties as a restraint on corporate management may counteract appeals for federal regulation to step in.

¹⁹ See *infra* Part II.A (discussing the history and nature of fiduciary duties).

²⁰ William T. Allen et al., *Function Over Form: A Reassessment of Standards of Review in Delaware Corporation Law*, 26 DEL. J. CORP. L. 859, 861 (2001).

²¹ See Ann M. Scarlett, *Confusion and Unpredictability in Shareholder Derivative Litigation: The Delaware Courts’ Response to Recent Corporate Scandals*, 60 FLA. L. REV. 589, 609 (2008).

²² See *In re Goldman Sachs Grp., Inc.*, No. CIV.A.5215-VCG, 2011 WL 4826104, at * 1 (Del. Ch. Oct. 12, 2011) (“Within the boundary of fiduciary duty, however, [officers and directors] are free to pursue corporate opportunities in any way that, in the exercise of their business judgment on behalf of the corporation, they see fit.”); Allen et al., *supra* note 20, at 861; see also *infra* notes 97, 101–102 and accompanying text.

important: (i) the substantive content of officer fiduciary duties (i.e., the standards of conduct); (ii) officers' accountability for breaches of their fiduciary duties (i.e., the standards of liability); and (iii) the enforcement scheme that detects breaches of fiduciary duties and holds officers accountable for those breaches. I have undertaken a three-part approach to looking at officer fiduciary duties that grapples with each of these components.

In a prior article, I addressed the first aspect — the *what* of fiduciary duties — discussing the differing views surrounding what the proper substantive content for officer, in contrast to directorial, fiduciary duties should be.²³ I suggested the duty of obedience as one way to correct some of the problems in corporate management.²⁴ As the second piece of this larger project, this Article looks at the enforcement scheme provided for under state law, specifically *who* has the ability to enforce officers' fiduciary duties and *how* they enforce those duties. This Article discusses problems with the current enforcement scheme and, as a result, how officers are rarely held responsible for violating their fiduciary obligations.

Underlying the belief that fiduciary duties shape management behavior are the assumptions that: (i) substantively, fiduciary duties can provide a sufficient constraint on officer conduct; and (ii) fiduciary duties will, in fact, be enforced so that individuals will be accountable for breaches of those duties and that enforcement and accountability will deter future misconduct. The focus of this Article is on the latter so it assumes, and thus puts aside the related question, that fiduciary duty principles are sufficient in this context to regulate officer conduct.²⁵ Starting from this premise, fiduciary duties will only have their intended and desired constraining effect on corporate management if they are actually enforced.²⁶ Stated another way, effective enforcement

²³ See Shaner, *Restoring the Balance*, *supra* note 13 at 36-50.

²⁴ *Id.*

²⁵ For a discussion of this question, see Celia R. Taylor, *The Inadequacy of Fiduciary Duty Doctrine: Why Corporate Managers Have Little to Fear and What Might Be Done About It*, 85 OR. L. REV. 993 (2007), which asserts that traditional fiduciary duty doctrine has devolved such that in its current form and application it does not control corporate behavior. In her article, Professor Taylor notes that “[i]f the fiduciary duty doctrine truly did perform this role, reliance on it as the watchdog of the corporate arena might be justified.” *Id.* at 1005; see also, e.g., Lyman P.Q. Johnson & Robert V. Ricca, *(Not) Advising Corporate Officers About Fiduciary Duties*, 42 WAKE FOREST L. REV. 663, 665 (2007) [hereinafter *(Not) Advising*] (noting that fiduciary duties are “widely thought to be one way to achieve better corporate governance”).

²⁶ Of course there are scholars who contend that extra-legal forces or sanctions can also adequately control management behavior and ensure that fiduciary duties have

preserves the ex ante²⁷ and ex post²⁸ power of fiduciary duties to shape officer conduct.

Indeed, scholars have repeatedly found that the law's regulation of behavior is only as good as the mechanisms that enforce it.²⁹ Specifically, social scientists have found that accountability (which is largely achieved through effective enforcement) can counteract human behavioral tendencies that undermine self-governance systems³⁰ and lead to unethical conduct.³¹ In addition, they have found that as the certainty of accountability for one's misconduct increases, so does the effectiveness of sanctions in deterring future misconduct.³² Thus, where the likelihood of accountability for one's actions is small, the incentive to comply with legal duties shrinks and can disappear, even when the standards of conduct and liability are appropriately drawn. In the absence of an effective enforcement scheme, fiduciary duties are

their desired effect. See, e.g., Melvin A. Eisenberg, *Corporate Law and Social Norms*, 99 COLUM. L. REV. 1253, 1260-65 (1999) (reputational concerns); Daniel R. Fischel, *The Corporate Governance Movement*, 35 VAND. L. REV. 1259, 1263-64 (1982) (market regulation); David M. Phillips, *Principles of Corporate Governance: A Critique of Part IV*, 52 GEO. WASH. L. REV. 653, 672-73 (1984) ("Extra-legal incentives, most notably those proffered by the existence and operation of certain markets, including the securities, executive employment, and products markets, already regulate managerial behavior.").

²⁷ Ex ante in that effective enforcement deters misconduct and encourages compliance with fiduciary duties.

²⁸ Ex post in that effective enforcement detects and sanctions officers for violating their fiduciary obligations.

²⁹ See J. Maria Glover, *The Structural Role of Private Enforcement Mechanisms in Public Law*, 53 WM. & MARY L. REV. 1137, 1142 (2012) (noting that "our system of regulation is only as good as the enforcement mechanisms underlying it"); see also TOM R. TYLER, *WHY PEOPLE OBEY THE LAW* 3 (2006) (referring to the model of human behavior that links legal compliance to the effectiveness of penalties as "instrumentalist").

³⁰ The corporate form and its distribution of decision rights and responsibilities have been described as being a self-governance or self-regulating system. See *ABA Report*, *supra* note 10, at 112 ("Directors and officers are required by law to act in the best interest of the corporation and its shareholders, thereby creating an efficient and accountable decision-making structure for entrepreneurial activity."); see also Rodrigues, *supra* note 4, at 44.

³¹ See Andrew Quinn & Barr R. Schlenker, *Can Accountability Produce Independence? Goals as Determinants of the Impact of Accountability on Conformity*, 28 PERSONALITY & SOC. PSYCHOL. BULL. 472, 480 (2002).

³² See Richard C. Hollinger & John P. Clark, *Deterrence in the Workplace: Perceived Certainty, Perceived Severity, and Employee Theft*, 62 SOC. FORCES 398, 399 (1983) ("[O]f the three major variables in the deterrence process — perceived certainty, severity, and celerity of punishment — the consensus of empirical research is that perceived certainty of punishment is the most effective in shaping behavior.").

inadequate in serving as a check on the power that is conferred upon officers.³³

As alluded to above, the enforcement scheme for fiduciary duties has two core components: (i) who can enforce (i.e., the corporate actors that have enforcement powers); and (ii) how enforcement works (i.e., the process involved in enforcing fiduciary duties). There are several different corporate actors that can play a role in enforcing officers' fiduciary obligations. The board of directors is the primary actor that has the ability to enforce officer fiduciary duties.³⁴ A corporation's stockholders also have enforcement powers.³⁵ Finally, creditors of the corporation can have, in very limited circumstances, the ability to enforce officer fiduciary duties.³⁶ Merely having the ability to enforce officers' legal duties does not, however, ensure that any of these three groups of corporate actors will do so. In fact, recent examples of officer misconduct and the near absence, even in Delaware, of case law discussing officers' fiduciary duties specifically suggest that these duties are not being enforced (at least by way of bringing lawsuits for violations).³⁷ While there may be many factors that influence whether

³³ This is a particularly important problem as scholars have noted that "the key goal that has informed much of corporate governance [is] the need to ensure an effective system of checks and balances that contains managers who are motivated to serve their own self-interests." Paredes, *Too Much Pay*, *supra* note 4, at 688.

³⁴ See *infra* notes 136–143 and accompanying text.

³⁵ See *infra* Part III.B.2.

³⁶ See *infra* Part III.B.3.

³⁷ There have only been a few recent instances where the Delaware courts have addressed fiduciary claims against officers (as distinct from directors). See, e.g., *Gantler v. Stephens*, 965 A.2d 695 (Del. 2009) (addressing claims that officers sabotaged an opportunity to sell the corporation); *Hampshire Grp., Ltd. v. Kuttner*, No. CIV.A.3607-VCS, 2010 WL 2739995 (Del. Ch. July 12, 2010) (addressing claims against officers for improper expense reimbursements and inaccurate financials); *ZRII, LLC v. Wellness Acquisition Grp., Inc.*, No. CIV.A.4374-VCP, 2009 WL 2998169 (Del. Ch. Sept. 21, 2009) (addressing allegations that officers breached their fiduciary duties when they conspired to take over or destroy their former employer); *In re Walt Disney Co.*, 907 A.2d 693, 778 n.588 (Del. Ch. 2005) ("The parties essentially treat both officer and directors as comparable fiduciaries, that is, subject to the same fiduciary duties and standards of substantive review. Thus, for purposes of this case, theories of liability against corporate directors apply equally to corporate officers, making further distinctions unnecessary."), *aff'd*, 906 A.2d 27 (Del. 2006). Related to the financial crisis, claims were brought against former directors and officers of AIG and Citigroup in *In re American International Group, Inc.*, 965 A.2d 763 (Del. Ch. 2009), and *In re Citigroup Inc.*, 964 A.2d 106 (Del. Ch. 2009). In both of these cases, however, the court did not address the fiduciary duties of individuals as officers as distinct from directors because the defendants served in a dual capacity for the corporations (and in the case of *In re American International Group, Inc.*, the court dismissed the claims against the non-director officers and employees on jurisdictional grounds). See 965 A.2d at 814-15.

the board, stockholders, or creditors exercise their enforcement powers, a principal consideration is the enforcement process itself.

In addressing this second component of enforcement, this Article discusses how corporate doctrine and the current dynamic in corporate management have created impediments and disincentives to enforcing officer fiduciary duties. For instance, the derivative lawsuit has been described as the “heart of accountability devices” and vital to a functioning system of internal corporate governance.³⁸ However, the development of the procedural requirements for derivative lawsuits, in particular where the actions of officers, and not directors, are being challenged, creates significant hurdles and results in a long and expensive process that discourages its use.³⁹ As a result, stockholders and creditors are deterred from using the chief enforcement mechanism available to them. Similarly, the board of directors, which serves as the primary check on officer power, is unlikely to enforce officer fiduciary duties. The narrowing of the standards of oversight liability,⁴⁰ coupled with the huge disparity in power between the board and the officers that frequently exists in the modern corporation,⁴¹ has resulted in the board being an ineffective enforcer.⁴²

The state of corporate law thus raises the concern that none of the parties eligible to bring an action to enforce officer fiduciary duties —

³⁸ Schwartz, *supra* note 18, at 324, 329; *see also infra* notes 243–251 and accompanying text.

³⁹ *See* Lisa M. Fairfax, *Spare the Rod, Spoil the Director? Revitalizing Directors' Fiduciary Duty Through Legal Liability*, 42 HOUS. L. REV. 393, 408-09 (2005) [hereinafter *Spare the Rod*] (“Scholars agree that the procedural rules related to derivative suits severely limit the ability of shareholders to bring legal actions to impose liability on directors for violating their fiduciary duty.”).

⁴⁰ *See* Stone *ex rel.* AmSouth Bancorporation v. Ritter, 911 A.2d 362, 372 (Del. 2006) (acknowledging that a violation of a board’s oversight duty is “possibly the most difficult theory [of liability] in corporation law”); Anne Tucker Nees, *Who’s the Boss? Unmasking Oversight Liability Within the Corporate Power Puzzle*, 35 DEL. J. CORP. L. 199, 215 (2010); Pan, *Rethinking the Board’s Duty to Monitor*, *supra* note 17, at 210 (criticizing Delaware doctrine as defining the duty of oversight too narrowly).

⁴¹ *See* MYLES L. MACE, DIRECTORS: MYTH AND REALITY 72-85, 190-94 (1971) (supporting the belief that officers, and not directors, play the central role in corporate affairs); Robert W. Hamilton, *Corporate Governance in America 1950–2000: Major Changes But Uncertain Benefits*, 25 J. CORP. L. 349, 360-64 (2000); Johnson & Millon, *supra* note 13, at 1614-17; Myles L. Mace, *The President and the Board of Directors*, HARV. BUS. REV., Mar.–Apr. 1972, at 37, 37-43 (describing the interaction of corporate directors and presidents).

⁴² *See* ABA Report, *supra* note 10, at 128 (“A legitimate criticism of corporate governance for much of the last century was that boards were unduly passive and deferential to the professional managers to whom they delegated authority for the daily operations of the company.”).

the board, the stockholders, and the creditors — will do so. Accordingly, this Article raises possible changes to corporate doctrine that would have the benefit of alleviating current deterrents in the enforcement process. Such proposals include reinvigorating the board of directors' duty of oversight and changes to derivative lawsuit procedural requirements.⁴³ Ultimately, this Article focuses on strengthening the stockholders' role in the enforcement scheme for officer fiduciary duties by way of lessening certain derivative litigation burdens.

This Article proceeds in the following manner. First, this Article begins by explaining the role corporate law intends officers to play in the structure of the corporation. Using examples of recent corporate scandals, it then discusses how officers have moved to a role with increasing power and the recurrent abuse of this power for their own personal gains. Part II of this Article summarizes why and how fiduciary duties are the primary constraint under state law on officer conduct. Finally, Part III focuses on the enforcement scheme for officers' fiduciary duties, discussing who can enforce these duties as well as the enforcement mechanisms available to them. This Part discusses how corporate law developments deter the board, stockholders and creditors from exercising their enforcement powers.

In Part IV, this Article concludes that in order to regulate officer behavior with fiduciary duties, there must be a collective correction to the enforcement mechanisms in place. To achieve the most effective enforcement, emphasis should be made on the mechanisms available to the internal enforcers of officers' duties — the board of the directors and stockholders. These corporate actors have the strongest incentives to participate in corporate governance and are generally the most efficient monitors and enforcers of officer behavior. Accordingly, proposed changes to the duty of oversight and derivative lawsuit requirements will have the greatest impact on improving enforcement incentives and ensuring officers are being held accountable for their fiduciary obligations. As between these two areas where reform would aid in strengthening enforcement, this Article focuses on proposals to ensure stockholders have meaningful enforcement mechanisms such as the derivative lawsuit available to them.

⁴³ See *infra* Part IV.B.1–IV.B.2.

I. THE CORPORATE OFFICER

A. *The Role of Officers*

“The corporate form is defined by the way it distributes decision rights and responsibilities among shareholders, the board and management.”⁴⁴ Organized as a hierarchical decision-making structure, primary authority to manage the business and affairs of a corporation is vested in the board of directors.⁴⁵ Recognizing that managing the day-to-day operations of a corporation may be a difficult task for a board of directors, corporate law allows the board to delegate this authority to the officers and, in fact, that is most often the case.⁴⁶ In the typical corporation, it is the officers who are charged with, and responsible for, running the business of the corporation.⁴⁷ This authority is not, however, unfettered. Officers only have such management power as the

⁴⁴ *ABA Report*, *supra* note 10, at 111; *see also* ADOLF A. BERLE, JR. & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 6-7 (Transaction Publishers 1991) (1932); Ribstein, *supra* note 17, at 196-98 (describing the corporate governance structure and decision-making hierarchy).

⁴⁵ *See* DEL. CODE ANN. tit. 8, § 141(a) (2014) (“The business and affairs of every corporation . . . shall be managed by or under the direction of a board of directors”); MODEL BUS. CORP. ACT § 8.01(b) (2006) (“All corporate powers shall be exercised by or under the authority of the board . . . and the business and affairs of the corporation shall be managed by or under the direction . . . of its board of directors”); *see also* Kaplan v. Peat, Marwick, Mitchell & Co., 540 A.2d 726, 729 (Del. 1988) (stating that it is a “basic principal of [Delaware law] that the business and affairs of a corporation shall be managed by the board of directors”).

⁴⁶ *See* DEL. CODE ANN. tit. 8, §§ 141(a), 142(a) (2014); *Grimes v. Donald*, No. CIV.A.13358, 1995 WL 54441, at *8 (Del. Ch. Jan. 11, 1995) (“Of course, given the large, complex organizations through which modern, multi-function business corporations often operate, the law recognizes that corporate boards, comprised as they traditionally have been of persons dedicating less than all of their attention to that role, cannot themselves manage the operations of the firm, but may satisfy their obligations by thoughtfully appointing officers, establishing or approving goals and plans and monitoring performance. Thus Section 141(a) of DGCL expressly permits a board of directors to delegate managerial duties to officers of the corporation, except to the extent that the corporation’s certificate of incorporation or bylaws may limit or prohibit such a delegation.” (citations omitted)), *aff’d*, 673 A.2d 1207 (Del. 1996); MODEL BUS. CORP. ACT §§ 8.01(b), 8.41 (2006). The board’s ability to delegate to others is not, however, limited to just the officers of the corporation. *See Grimes*, 1995 WL 54441, at *8-9.

⁴⁷ *See* 1 R. FRANKLIN BALOTTI & JESSE A. FINKELSTEIN, *THE DELAWARE LAW OF CORPORATIONS AND BUSINESS ORGANIZATIONS* § 4.10[B] (3d ed. 2014) (stating that “normally it is the officers to whom the primary functions of management are delegated”); Ribstein, *supra* note 17, at 188 (“[T]he corporate form of centralized management involves dividing management between professional full-time executives who manage the firm day-to-day and directors who oversee the board and set policy.”).

corporation's governing documents or board resolutions provide.⁴⁸ Further, at all times the board of directors retains its power and authority to manage the corporate enterprise and officers are subject to the ultimate control and oversight of the board.⁴⁹ Finally, the stockholders, as the residual claimants, occupy the bottom of the decision-making hierarchy, holding very few management rights with certain statutory exceptions.⁵⁰

Officers have not always occupied the predominant role in managing the corporate enterprise that they do today. Corporate law contemplates that the board of directors will function as a "super management" body that reviews and approves corporate strategies.⁵¹ Officers then carry out those broad corporate strategies in handling the day-to-day operations of their companies.⁵² The board, however, still remains actively involved in corporate management.⁵³ Over the years, this role of the board has changed, delegating more and more responsibilities to officers and moving towards a more supervisory body.⁵⁴ Outside of

⁴⁸ Officers are appointed or elected by the board of directors and their titles, powers and authority are typically prescribed in the bylaws or in a resolution of the board. *See* DEL. CODE ANN. tit. 8, § 142(a)–(b). "Typical functions of the officers include entering into ordinary business transactions, devising business strategies, setting business goals, managing risks, and generally working with subordinates to '[p]lan, direct, or coordinate operational activities.'" Johnson & Ricca, *Reality Check*, *supra* note 4, at 78-79 (internal citations omitted).

⁴⁹ *See* DEL. CODE ANN. tit. 8, § 141(a) (providing that the business and affairs of the corporation are to be carried out under the direction of the board); *see also* Graham v. Allis-Chalmers Mfg. Co., 188 A.2d 125, 130-31 (Del. 1963) (providing for the duty of oversight); Unanue v. Unanue, No. 204-N, 2004 WL 5383942, at *15 (Del. Ch. Nov. 9, 2004) ("It is well settled that officers of a corporation serve at the pleasure of the board of directors."); *In re* Caremark Int'l Inc., 698 A.2d 959, 968-70 (Del. Ch. 1996). As explained by the ABA Section of Business Law, "The board . . . typically delegates significant authority for the day-to-day operations to a professional CEO and other executive officers, who in turn derive their management authority from the board of directors. To the extent that a board delegates its management, it must exercise reasonable oversight and supervision over management." *ABA Report*, *supra* note 10, at 122-23.

⁵⁰ *See* BERLE & MEANS, *supra* note 44, at 5-7.

⁵¹ *See* JAMES D. COX & THOMAS LEE HAZEN, *CORPORATIONS* 137 (2d ed. 2003); *see also* BALOTTI & FINKELSTEIN, *supra* note 47, § 4.1 ("The board's customary duties and obligations are, in and of themselves, quite varied and far ranging.").

⁵² *See supra* notes 47-49 and accompanying text.

⁵³ *See* BERLE & MEANS, *supra* note 44, at 5-7.

⁵⁴ *See* Johnson & Millon, *supra* note 13, at 1621 ("[U]ntil the 1970s, most corporate statutes provided that boards of directors actually were to 'manage' the corporation Legal form eventually yielded to institutional reality for directors, as corporate statutes were amended to provide that the management function need only be under the board's 'direction.'"). This is most often the case at large, public corporations. *See* Claire Hill &

those statutorily required director actions, the majority of a board's time and energy are spent on compliance and oversight duties as opposed to active management. Indeed, it is a widely held view that today's board of directors is primarily a supervisor, monitoring the officers' stewardship of the corporation.⁵⁵

As the management role of officers has expanded, the dynamic between the board of directors and officers has also shifted. At all times, officers are subordinate to the ultimate control and authority that is vested in the board.⁵⁶ Over the past few decades, however, senior executive officers' power and authority have greatly increased. Scholars have cited several factors as contributing to the predominance of officers. As one scholar described the shift in control of the corporation:

[O]nce an increasing number of firms failed to have a controlling shareholder in place, [then] the CEO was able to run the daily operations of the firm and could handpick nominees to the board. The result of that change was that the board was effectively inferior to the CEO it was supposed to supervise.⁵⁷

Others have pointed out that as executive officers took on greater management responsibility, they were also afforded greater latitude in carrying out their duties.⁵⁸ This then led to a culture of deference to the actions and decisions of officers.⁵⁹ Relatedly, directors (in comparison

Brett McDonnell, *Executive Compensation and the Optimal Penumbra of Delaware Corporate Law*, 4 VA. L. & BUS. REV. 333, 343 (2009).

⁵⁵ See COX & HAZEN, *supra* note 51, at 137; Omari Scott Simmons, *The Corporate Immune System: Governance from the Inside Out*, 2013 U. ILL. L. REV. 1131, 1144-46 ("Undoubtedly, the responsibilities of boards of directors have increased significantly over time, especially related to their monitoring and oversight roles." (citation omitted)); *infra* notes 177-178 and accompanying text. *But see* Bainbridge, *The Means and Ends*, *supra* note 2, at 559-60, 605-06 (asserting the director primacy model and that boards of directors, not stockholders or managers, control corporations).

⁵⁶ See DEL. CODE ANN. tit. 8, §§ 141(a), 142 (2014).

⁵⁷ Alces, *supra* note 11, at 788-89 (noting that the "board's role 'became advisory rather than supervisory'" (internal quotation marks omitted)); *see also* JAY W. LORSCH & ELIZABETH MACIVER, PAWNS OR POTENTATES: THE REALITY OF AMERICA'S CORPORATE BOARD 20 (1989).

⁵⁸ See *ABA Report*, *supra* note 10, at 128.

⁵⁹ See *id.*; Aviram, *supra* note 13, at 777-78 (describing the ways that officers can dominate the board as being (i) collusive (e.g., the board willingly deferring to the officer because of things like the officer's "star power") or (ii) noncollusive (e.g., the officer dominating by "controlling the board's agenda, the amount of time the board has to react to new information, or the amount and types of information they supply to the board")); Lin, *supra* note 4, at 363-73 (describing the organizational and legal deference given to iconic executives); Paredes, *Too Much Pay*, *supra* note 4, at 721-22 (describing

to officers) operate at an informational disadvantage with respect to the corporation's performance and strategic opportunities,⁶⁰ facing time constraints in discharging their management duties⁶¹ which further contributes to officers' dominance. As a result, many scholars and commentators have noted that senior executive officers have all but subsumed the board of directors' role as the central decision-making body in the corporation.⁶²

The role reversal in corporate management has led to officers, in particular the chief executive officer, becoming perhaps the most influential persons in the corporate enterprise. These individuals occupy "recognized positions of immense economic and social influence," drawing "widespread attention in the larger cultural arena"⁶³ and, as discussed more fully in the next section, the conduct of officers can dramatically impact the fortunes and failures of a corporation's business. As described in 2002 by then-Chairman of the Federal Reserve Alan Greenspan, senior executive officers are "the fulcrum of [corporate] governance."⁶⁴ While the presence of strong corporate officers can provide many advantages to a corporation, they

how subordinate officers, gatekeepers, boards and stockholders defer to the CEO, resulting in these individuals having additional "de facto power").

⁶⁰ See *ABA Report*, *supra* note 10, at 128.

⁶¹ See *id.*; Johnson & Ricca, *Reality Check*, *supra* note 4, at 80 ("Even under a conservative estimate that officers spend fifty hours per week on the job, that would be 200 hours per month, which means that officers spend around ten times the amount of time that directors spend in fulfilling their duties to the corporation.").

⁶² See ALFRED F. CONRAD, *CORPORATIONS IN PERSPECTIVE* 349-50 (1976) ("[D]irectors do not supervise and control executives; rather, they are supervised and controlled by the executives."); LORSCH & MACIVER, *supra* note 57, at 20; see also Arthur J. Goldberg, *Debate on Outside Directors*, N.Y. TIMES, Oct. 29, 1972, at F1 (stating that the modern board of directors has been "relegated to an advisory and legitimizing function that is substantially different from the role of policy maker and guardian of shareholder and public interest contemplated by the law of corporations"). In 2009, the Task Force of the ABA Section of Business Law's Corporate Governance Committee published a report addressing the governance roles and responsibilities in corporations in which it found that "[t]hroughout much of the last century, the professional managers hired to run public companies have wielded significant power in relation to both the board of directors and shareholders." *ABA Report*, *supra* note 10, at 128. *But see* Bainbridge, *The Means and Ends*, *supra* note 2, at 561-62 ("The board-capture phenomenon seems less valid today, however, than it once was.").

⁶³ Lyman Johnson & Dennis Garvis, *Are Corporate Officers Advised About Fiduciary Duties?*, 64 BUS. LAW. 1105, 1106 (2009).

⁶⁴ Testimony of Chairman Alan Greenspan, *supra* note 10; see also Remarks of Chairman William H. Donaldson, *supra* note 10 ("Over the past decade or more, at too many companies, the chief executive position has steadily increased in power and influence. In some cases, the CEO has become more of a monarch than a manager.").

also can (and frequently do) create significant governance problems.⁶⁵ Accordingly, recent corporate governance reform has begun to turn its focus, in part, on how to rein in the officer.⁶⁶

B. Officer Misconduct

Classic agency theory assumes that agents will act in their own self-interest over, and many times at the expense of, their principal's best interests.⁶⁷ The agency model of managerial decision-making in the corporate structure raises these same concerns about opportunistic managers. As Berle and Means described in their canonical account of the corporation, the "separation of ownership from control produces a condition where the interest of owner and of the ultimate manager may, and often do, diverge."⁶⁸ Stating the problem slightly differently, former SEC Commissioner Troy Paredes explained that "there is no reason to assume that managers are necessarily motivated to maximize shareholder value. To the contrary, . . . if unchecked, [managers] will place their own self-interest before the best interest of the corporation and its shareholders."⁶⁹ Unfortunately there have been several

⁶⁵ See Lin, *supra* note 4, at 362-80 (discussing how corporate governance dangers are particularly heightened in the case of "iconic executives").

⁶⁶ See, e.g., Dodd-Frank, Pub. L. No. 111-203, §§ 951, 952, 124 Stat. 1376, 1899, 1900 (2010) (codified at 15 U.S.C. §§ 78j, 78n) (providing for stockholder advisory votes on executive compensation, independent compensation committees, and disclosure of executive compensation); Sarbanes-Oxley Act, Pub. L. No. 107-204, § 302, 116 Stat. 745, 777 (2002) (codified at 15 U.S.C. §§ 78m, 78o) (requiring a public corporation's chief executive officer and chief financial officer to certify financial reports filed under the federal securities laws); *ABA Report*, *supra* note 10, at 128 ("Considerable scholarly discussion and debate in the fields of economics, law, and organizational behavior have grappled with the issue of how the governance system can best protect . . . shareholders from the potential for the self-interest of autonomous managers in light of the lack of independence and active oversight by directors." (citations omitted)). Self-regulatory organizations such as the New York Stock Exchange and NASDAQ have also adopted regulations aimed at regulating corporate director and officer conduct. See Johnson & Millon, *supra* note 13, at 1614-15; Sale, *Delaware's Good Faith*, *supra* note 16, at 456-57.

⁶⁷ See Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 308-10 (1976); see also William W. Bratton, *Hedge Funds and Governance Targets*, 95 GEO. L.J. 1375, 1397 (2007) ("According to classic agency theory, problems of opportunism and adverse selection among managers generate 'agency costs' that impair corporate performance.").

⁶⁸ BERLE & MEANS, *supra* note 44, at 7; see also *ABA Report*, *supra* note 10, at 111 (stating that historically one of the major concerns with the corporate form is that it provides an opportunity for managers to act in their own self-interest over the stockholders').

⁶⁹ Paredes, *Too Much Pay*, *supra* note 4, at 684; see also Cox, *supra* note 17, at 11 ("Indeed, there is hardly any behavior within the corporate setting that cannot be linked

prominent examples of this happening over the past fifteen years — officers acting in self-interested manners to the detriment of the stockholders.⁷⁰

In 2001, Enron Corporation was the seventh largest American corporation and had been labeled the “Most Innovative Company in America.”⁷¹ Not even a year later, however, Enron’s stock price plummeted as it had to restate its financials to expose a \$500 million accounting loss, ultimately leading the company to file for bankruptcy.⁷² What was revealed to have caused such a prominent corporation to fall so quickly was accounting manipulation, false and misleading financial disclosures made to hide the company’s true financial condition, large monetary payments to senior officers, and conflicted transactions with senior officers.⁷³ What happened at Enron was not an aberration. WorldCom, Adelphia, Tyco, and many other corporations followed closely thereafter with similar stories of financial fraud and malfeasance by their respective senior officers emerging.⁷⁴ These events prompted the corporate community to reevaluate and rethink corporate governance norms and policy, leading to the enactment of Sarbanes-Oxley and regulatory reform from the New York Stock Exchange and NASDAQ.⁷⁵ Recognizing the role senior executives played in these events, part of this reform was directly aimed at regulating the conduct of corporate officers.⁷⁶ In reflecting on the extensive fraudulent financial activity at many large public

to advancing a manager’s self-interest.”).

⁷⁰ Examples of managerial self-interest are not, of course, limited to the twenty-first century. See Cox, *supra* note 17, at 11 (describing other instances of misbehavior including antitrust and environmental violations).

⁷¹ See William W. Bratton, *Enron and the Dark Side of Shareholder Value*, 76 TUL. L. REV. 1275, 1276-99 (2002) [hereinafter *The Dark Side*] (describing the Enron collapse).

⁷² See Gordon, *supra* note 10, at 1233-35; Hamilton, *2002 Style*, *supra* note 10, at 10-11.

⁷³ See Bratton, *The Dark Side*, *supra* note 71, at 1276-99; Gordon, *supra* note 10, at 1233-35 (describing the events at Enron including “the bad news, the reported conflict of interest, an ensuing SEC investigations and the fall in Enron’s stock price,” as well as “Enron’s troubled financial relationship with officer-managed partnerships”). For example, “The Wall Street Journal reported that \$35 million of the losses derived from business dealings with partnership managed by the company’s CFO, Andrew S. Fastow.” *Id.*

⁷⁴ See Hamilton, *2002 Style*, *supra* note 10, at 13-33 (describing the corporate scandals from 2001 to 2002); see also *Executives on Trial*, *supra* note 5, at B1 (detailing criminal charges and investigations involving corporate officers).

⁷⁵ Hamilton, *2002 Style*, *supra* note 10, at 40-45 (detailing the responses to Enron and other financial accounting scandals).

⁷⁶ See *supra* note 15 and accompanying text.

corporations, scholars agreed that what was exposed was: “(1) officers [running] amok, wallowing in greed-driven schemes and other abuses; and (2) directors allow[ing] it to happen, tolerating officers who were managing the market while they contented the directors with ever-rising stock prices.”⁷⁷

Not long after Enron, stock option backdating practices came to light. In 2005 and 2006, investigations of option backdating at numerous public corporations were made, most notably at Apple, Broadcom, McAfee, Inc., and Peregrine Systems, Inc.⁷⁸ Top corporate officers were allegedly receiving huge windfalls through the grant of stock options with an exercise price based on a trading price from an earlier date which was much lower than the current market price. The public disclosures regarding these options, however, falsely stated that they had been issued at an “at market” exercise price.⁷⁹ Option backdating quickly became the new corporate scandal, prompting numerous SEC investigations, private lawsuits, and some criminal convictions.⁸⁰ The

⁷⁷ Veasey, *supra* note 6, at 441-42; see COX & HAZEN, *supra* note 51, at 145 (“Enron, WorldCom, and no fewer than a dozen other large public companies shocked the public conscience, not because they failed, but because of the revelations of extensive reporting frauds, overreaching, and wasteful behavior by their most senior executives.”); Johnson & Millon, *supra* note 13, at 1599-1602 (pointing out that leading up to the financial scandals in 2001–2002 “[c]orporate interests were left unprotected as officers operated free of any meaningful director supervision”); Sale, *Delaware’s Good Faith*, *supra* note 16, at 461-62; see also Am. Bar Ass’n Task Force on Corporate Responsibility, *Preliminary Report of the American Bar Association Task Force on Corporate Responsibility*, 58 BUS. LAW. 189, 189-90 (2002) (“[Enron] is merely one of the most notorious in a disturbing series of recent lapses at large corporations involving false or misleading financial statements and alleged misconduct by executive officers.”).

⁷⁸ See Shannon German, *What They Don’t Know Can Hurt Them: Corporate Officers’ Duty of Candor to Directors*, 34 DEL. J. CORP. L. 221, 236-54 (2009) (describing option backdating cases); Mark Lebovitch & Laura Gundersheim, “Novel Issues” or a Return to Core Principles? *Analyzing the Common Link Between the Delaware Chancery Court’s Recent Rulings in Option Backdating and Transactional Cases*, 4 N.Y.U. J.L. & BUS. 505, 507 (2008); see also Ryan v. Gifford, 918 A.2d 341, 346-48 (Del. Ch. 2007) (addressing backdating allegations). Other forms of value inflation in option grants that were also discovered included spring-loading options and bullet dodging. See, e.g., *In re Tyson Foods, Inc.*, 919 A.2d 563, 593 (Del. Ch. 2007) (addressing spring-loading allegations); *Desimone v. Barrows*, 924 A.2d 908 (Del. Ch. 2007) (addressing allegations of backdating, spring-loading, and bullet dodging).

⁷⁹ See Lebovitch & Gundersheim, *supra* note 78, at 518-20; Timothy P. Stone, *The Rise and Fall of Options Backdating: From Executive Windfall to Executive Pitfall*, 76 DEF. COUNS. J. 174, 175-76 (2009) (describing option backdating practices); Marcy Gordon, *Is Backdating the New Corporate Scandal?*, CORP. COUNS. (June 5, 2006), <http://www.corpcounsel.com/id=900005455054/Is-Backdating-the-New-Corporate-Scandal?slreturn=20140711211718>.

⁸⁰ See Stone, *supra* note 79, at 178-184 (noting that “[a]s of March 2008, seven

end result of what was uncovered has been described as “cheating the corporation in order to give the CEO more money than was authorized”⁸¹ and “the greed of executives.”⁸²

More recently, Wall Street giants like Lehman Brothers, AIG, Bear Stearns, and Merrill Lynch were at the center of the financial crisis. In 2007, the U.S. housing bubble burst, triggering a series of events that led to the eventual bankruptcy of Lehman Brothers and others, the bailout of Citibank and Bank of America by the federal government, and damage to stock markets worldwide.⁸³ Similar to Enron and stock option backdating, breakdowns in corporate governance, including the officer-dominated model of corporate management and officer malfeasance, were cited as a cause (although not the only cause) of the crisis.⁸⁴ Again, in the aftermath of such a large-scale scandal, regulators and legislators took action by adopting Dodd-Frank.⁸⁵ While Dodd-

general counsels and twenty-nine corporate executives had been charged” by the SEC and that reports on private actions filed against corporations for backdating practices ranged from sixteen to as many as fifty-seven); *see also* Gordon, *supra* note 79 (“The newest intrigue in corporate America, the apparent backdating of stock options to boost top executives’ compensation, is rapidly taking on the dimensions of a major scandal.”).

⁸¹ Gordon, *supra* note 79 (quoting Columbia University law professor John C. Coffee); *see also* LUCIAN BEBCHUK & JESSE FRIED, *PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION* 165 (2004) (stating that backdating was a way of “rewarding managers when stock prices fall”).

⁸² Gordon, *supra* note 79 (quoting Richard Hans, a securities and corporate governance attorney at Thacher Proffitt & Wood in New York); *see also* Lebovitch & Gundersheim, *supra* note 78, at 519 (“At its core, therefore, stock option backdating and spring-loading involves fiduciaries manipulating a corporate process [in] order to line their own pockets at the expense of the corporation and its shareholders.”).

⁸³ *See* Dallas, *supra* note 10, at 281-93 (describing the events that took place leading up to and during the financial crisis).

⁸⁴ *See, e.g.*, Press Release, Fin. Crisis Inquiry Comm’n, Financial Crisis Inquiry Commission Releases Report on the Causes of the Financial Crisis (Jan. 27, 2011), available at http://fcic-static.law.stanford.edu/cdn_media/fcic-news/2011-0127-fcic-releases-report.pdf (listing “[d]ramatic breakdowns in corporate governance including too many financial firms acting recklessly and taking on too much risk” as one of the causes of the financial crisis); *see also* Stephen M. Bainbridge, *Caremark and Enterprise Risk Management*, 34 J. CORP. L. 967, 968 (2009) [hereinafter *Caremark*] (asserting that the financial crisis “revealed serious risk management failures on an almost systemic basis throughout the business community” and that there were “absent or poorly implemented risk management programs” at corporations); Dallas, *supra* note 10, at 281-93 (asserting that short-termism by corporate management, asset managers and investors contributed to the financial crisis). *But see* Robert T. Miller, *Oversight Liability for Risk-Management Failures at Financial Firms*, 84 S. CAL. L. REV. 47, 50-57 (2010) (asserting that excessive risk-taking can have different forms and that the financial crisis may have been caused by socially inefficient risk-taking or excessive systemic risk and not, as many people believe, significant failures of risk-management systems).

⁸⁵ *See* Dodd-Frank, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified in

Frank was passed, in large part, to provide greater financial regulations, it also contains several provisions with the purpose of regulating the governance of public corporations. For example, through rules and regulations such as “say on pay” and “say when on pay,” legislators and regulators have sought to rein in the officer through the purse strings of the corporation by requiring stockholder voting on executive compensation and independent compensation committees.⁸⁶ Further, in support of the proposed rules providing for stockholder proxy access for director nominees, proponents cited both the failure of management to act in the best interests of the corporation as well as the lack of accountability of management to the stockholders.⁸⁷

The events surrounding each of these scandals support the apparent role reversal in corporate management and the corresponding belief that senior executive officers have come to dominate corporate decision-making.⁸⁸ As one set of scholars has pointed out, “[m]uch of the recent corporate wrongdoing involves senior officers, many of whom . . . were not members of the board.”⁸⁹ These events also illustrate the importance

scattered sections of 5 U.S.C., 7 U.S.C., 12 U.S.C., 15 U.S.C., 22, U.S.C., 26 U.S.C. and 28 U.S.C.).

⁸⁶ “Say on pay” requires that public corporations have periodic stockholder advisory votes on executive compensation. Dodd-Frank § 951. The “say on pay” stockholder vote must occur not less than once every three years. *See id.*; Securities Exchange Act of 1934 § 14A, 15 U.S.C. § 78n-1 (2010). In addition, “say when on pay” rules require that public corporations have their stockholders vote, at least once every six years, on how frequently the “say on pay” vote should occur — every one, two or three years. Dodd-Frank § 951. The results of both the “say on pay” and “say when on pay” votes must be disclosed by the corporation in a public filing with the SEC. *Id.* Dodd-Frank also mandates that compensation committees responsible for setting senior executive pay be independent. *Id.* § 952.

⁸⁷ *See* Shareholder Bill of Rights Act of 2009, S. 1074, 111th Cong. § 2 (2009) (“[W]ithin too many of the Nation’s most important businesses and financial institutions, both executive management and boards of directors have failed in their most basic duties.”).

⁸⁸ *See* ABA Report, *supra* note 10, at 132 (“Most recently, instances of collapse or near collapse of financial services firms . . . has been cited by observers as evidence of ineffective boards still caught in a culture of undue deference to chief executive officers and their teams.”); Rodrigues, *supra* note 4, at 1 (stating that the fraud at Enron, WorldCom, option backdating and payouts to high-level officers as financial institutions verged on self-destruction “required not only affirmative fraudulent behavior on the part of a few, but also the tacit acceptance of individuals throughout the company”). *See generally* Hillary A. Sale, *Monitoring Caremark’s Good Faith*, 32 DEL. J. CORP. L. 719, 754 (2007) [hereinafter *Monitoring Caremark’s Good Faith*] (“Studies have revealed a connection between higher levels of CEO dominance and the presence of backdating problems.”).

⁸⁹ Johnson & Sides, *supra* note 16, at 1219; *see* Rodrigues, *supra* note 4, at 3 (stating that the “common denominator” in Enron, WorldCom, option backdating, corporate,

of officers in the corporate structure and their disturbingly frequent misuse of their influential positions for personal gain.⁹⁰ Of course, the actions of corporate officers were one of several contributing factors. Nevertheless, the recurring theme of officer malfeasance winding its way through the past fifteen years should not be ignored. Major scandals like these raise corporate governance concerns and questions about perceived shortcomings in the current system of checks and balances on management power intended to deter misconduct and hold misbehaving managers accountable.⁹¹ One such important check under state law is fiduciary principles requiring officers to place the interests of the corporation and its stockholders before their own.

II. FIDUCIARY DUTIES OF OFFICERS⁹²

The imposition of fiduciary duties on corporate decision makers . . . is widely thought to be one way to achieve better corporate governance.⁹³

A. *The Nature of Fiduciary Duties*

Historically, the corporation and its management were subject to strong state control through statutory law. A special chartering system, which later gave way to incorporation statutes, provided mandatory

looting, insider trading and out-sized executive compensation is the self-interested actions of corporate officers); Testimony of Chairman Alan Greenspan, *supra* note 10 (“Manifestations of lax corporate governance, in my judgment, are largely a symptom of a failed CEO.”).

⁹⁰ See *supra* notes 5–7 and accompanying text.

⁹¹ See Lisa M. Fairfax, *Form Over Substance? Officer Certification and the Promise of Enhanced Personal Accountability Under the Sarbanes-Oxley Act*, 55 RUTGERS L. REV. 1, 3–4 [hereinafter *Form Over Substance*] (“Yet if the current climate serves as any indicator, the existing law has not served to promote personal responsibility among corporate officers.”); Sale, *Monitoring Caremark’s Good Faith*, *supra* note 88, at 720 (noting that corporate scandals “raise . . . questions about the place of officers, the role of the board, the appropriate measure for fiduciary duties, and the corporate-governance structure more generally”); see also Coffee, *Understanding Enron*, *supra* note 10, at 1404–05 (asserting that Enron’s implosion demonstrates that professional gatekeepers (e.g., auditors and analysts) failed); Paredes, *Too Much Pay*, *supra* note 4, at 680.

⁹² This Article primarily focuses on Delaware law with respect to its discussions of fiduciary duties and enforcement mechanisms as Delaware case law and statutes are generally considered the leading source for corporate law. See William T. Allen, *The Pride and Hope for Delaware Corporate Law*, 25 DEL. J. CORP. L. 70, 71 (2000) (stating that the DGCL “is certainly the nation’s and indeed the world’s leading organization law for large scale business enterprise”). See generally Ribstein, *supra* note 17, at 230 (noting the “continued dominance of Delaware corporation law”).

⁹³ Johnson & Ricca, (*Not*) *Advising*, *supra* note 25, at 665.

rules and strict regulation of corporate operations.⁹⁴ As both the American economy and a corresponding demand for the corporate form grew, these strict corporate statutes became inefficient and were loosened to create what today is now an enabling statutory regime.⁹⁵ This new formation of corporate regulation provided flexibility to management in structuring and running the corporate enterprise.⁹⁶ At the same time, “what emerged as a counterpoint to the evolution of [this] enabling model of corporation law was the second key function of the law of corporations: the ex post judicial review of the actions of corporate officers and directors, measured by fiduciary principles.”⁹⁷ In contrast to early statutory corporate law, fiduciary duties are largely (if not exclusively in jurisdictions such as Delaware) a creature of common law, evolving incrementally and finding their roots and subsequent development in the decisions of the courts.⁹⁸ This has provided the courts with the flexibility to respond to an ever-changing business world by engaging in case-by-case analysis of corporate conduct.

The majority of fiduciary duty doctrine has and continues to develop in the director context. Directors are entrusted with management responsibility of the corporation for the benefit of the corporation, effectively serving in a trustee-like role.⁹⁹ In fulfilling their managerial

⁹⁴ See JAMES WILLARD HURST, *THE LEGITIMACY OF THE BUSINESS CORPORATION IN THE LAW OF THE UNITED STATES 1780–1970*, at 132-35 (1970); Taylor, *supra* note 25, at 998-1006. See generally Allen et al., *supra* note 20, at 861 (describing the evolution of corporation law and the function of fiduciary duties).

⁹⁵ See HURST, *supra* note 94, at 70-71; Leo E. Strine, Jr., *The Inescapably Empirical Foundation of the Common Law of Corporations*, 27 DEL. J. CORP. L. 499, 501 (2002) [hereinafter *Empirical Foundation*]; Taylor, *supra* note 25, at 998-1000.

⁹⁶ See *In re Goldman Sachs Grp., Inc.*, No. CIV.A.5215-VCG, 2011 WL 4826104, at * 1 (Del. Ch. Oct. 12, 2011); *supra* note 20 and accompanying text.

⁹⁷ Allen et al., *supra* note 20, at 861; see Allen, *supra* note 92, at 72 (“The most remarkable feature of U.S. corporation law generally, and Delaware particularly, is the great importance that it gives to the fiduciary duty concept and the resulting power of courts to apply ex post evaluations of many important types of transactions.”); Holland, *supra* note 17, at 678 (stating that fiduciary duties “are an equitable response to the power that is conferred upon directors as a matter of statutory law”); Taylor, *supra* note 25, at 1005-06 (“Specifically, corporate fiduciary duties were said to provide any necessary protection lost by the loosening of other regulation.”).

⁹⁸ See *In re Citigroup Inc.*, 964 A.2d 106, 114 n.6 (Del. Ch. 2009); E. NORMAN VEASEY & CHRISTINE T. DI GUGLIELMO, *INDISPENSABLE COUNSEL: THE CHIEF LEGAL OFFICER IN THE NEW REALITY*, 133-37 (2012); see also Simmons, *supra* note 55, at 1160.

⁹⁹ See DEL. CODE ANN. tit. 8, § 141(a) (2014); *Guth v. Loft, Inc.*, 5 A.2d 503, 510 (Del. 1939) (“While technically not trustees, [officers and directors] stand in a fiduciary relation to the corporation and its stockholders.”); BALOTTI & FINKELSTEIN, *supra* note 47, § 4.14 (“The board of directors is responsible for managing the corporation’s business and affairs for the benefit of the stockholders.”).

responsibilities, directors of Delaware corporations are thus charged with continual, unyielding fiduciary duties of care and loyalty to the corporation and the stockholders.¹⁰⁰ In effect, fiduciary obligations serve as the principle restraint on the broad management powers provided to the board of directors — requiring certain minimum standards of conduct.¹⁰¹ As Chief Justice Strine of the Delaware Supreme Court has explained, “This fiduciary restraint enables stockholders to benefit safely from the flexibility of the [Delaware statutes’] enabling approach because the common law limits the ability of directors to abuse that flexibility for their own self-interest at the stockholders’ expense.”¹⁰²

B. Officer Fiduciary Duties

Like directors, officers are also given wide latitude under corporate law norms to carry out their role in running the corporation. As discussed above, the delegation of authority coupled with the enormous discretion and deference afforded to officers has led to these individuals wielding incredible power in controlling the corporate enterprise. Aside from specific restrictions imposed by the board of directors or in the corporation’s governing documents, the primary constraint under state law on officers’ power is their fiduciary obligations. Indeed, “[c]orporate fiduciary duties have long been considered vital in

¹⁰⁰ See *Mills Acquisition Co. v. Macmillan, Inc.*, 559 A.2d 1261, 1280 (Del. 1989) (“The fiduciary nature of a corporate office is immutable.”); *Phillips v. Insituform of N. Am., Inc.*, No. CIV.A.9173, 1987 WL 16285, at *10 (Del. Ch. Aug. 27, 1987) (stating that the “law demands of directors . . . fidelity to the corporation and all of its shareholders”); see also *WELCH ET AL.*, *supra* note 3, § 141.2, GCL-IV-23–24.

¹⁰¹ See Ribstein, *supra* note 17, at 201 (“Although the board’s power is not plenary, it is subject mainly to court-imposed fiduciary duties rather than firm-specific arrangements.”); Strine, *Empirical Foundation*, *supra* note 95, at 501 (“Delaware’s enabling statute is premised on its use within a system of corporate law that uses . . . fiduciary duties as an additional restraint on director action.”); Taylor, *supra* note 25, at 1025 (“Recall the main justifications for imposing mandatory corporate fiduciary duties: first, promoting trust and protecting parties from the actions of directors with conflicting interests, and second, ensuring that directors make all decisions with the interests of their shareholders in mind.”).

¹⁰² Strine, *Empirical Foundation*, *supra* note 95, at 501; see *ABA Report*, *supra* note 10, at 147 (“The current state law framework that gives the board authority for the business and affairs of the corporation within a framework of fiduciary duties owed to shareholders creates an efficient decision-making structure for engaging in entrepreneurial actions for the benefit of the equity providers and ultimately our economy at large.”); Rodrigues, *supra* note 4, at 5 (“[S]tate corporate law, of course, does focus on the internal governance of the corporation via fiduciary duties.”).

controlling corporate management.”¹⁰³ Even more so today than arguably ever before, fiduciary duties are an important check on the self-interest of a powerful officer.

While scholars disagree over whether officers' fiduciary obligations arise out of their status as agents of the corporation or as a result of their trustee-like role akin to that of directors,¹⁰⁴ it is undisputed that they owe some form of fiduciary duties to the corporation and its stockholders.¹⁰⁵ The source of the confusion and debate in this area has been the result of surprisingly little case law or commentary on the exact nature and scope of officer fiduciary duties.¹⁰⁶ For decades, even in Delaware which is the leading jurisdiction for corporate law, the courts had only intimated in a few of their opinions that officers owed the same fiduciary duties as directors without any further explanation.¹⁰⁷ As a result, corporate officers and their counsel were left

¹⁰³ Taylor, *supra* note 25, at 1005-06 (“Common law would provide what statutes did not: managers could move freely in the corporate universe, but their movements would be held in check, not by substantive regulation, but by certain minimum standards imposed by fiduciary duties.”); see Allen et al., *supra* note 20, at 862 n.5 (describing fiduciary law as “a set of principles governing behavior”); see also *In re Citigroup*, 964 A.2d at 114 n.6 (“In defining [fiduciary duties], the courts balance specific policy considerations such as the need to keep directors and officers accountable to shareholders and the degree to which the threat of personal liability may discourage beneficial risk taking.”).

¹⁰⁴ See Shaner, *Restoring the Balance*, *supra* note 13, at 36-43 (summarizing the debate over the nature of officer fiduciary duties). Compare Johnson & Millon, *supra* note 13 (advocating for agency law-based fiduciary duties), with Sparks & Hamermesh, *supra* note 13 (asserting that director-like fiduciary duties are the proper standard).

¹⁰⁵ See 3 WILLIAM MEADE FLETCHER, FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 837.50 (rev. vol. 2002) (“[C]orporate directors and officers occupy a fiduciary capacity”); Johnson & Ricca, (*Not Advising*, *supra* note 25, at 669 (“What apparently is not controversial, however, is that officers owe fiduciary duties of some sort”).

¹⁰⁶ See BALOTTI & FINKELSTEIN, *supra* note 47, § 4.10[C] (“Few authorities deal with the nature of the obligation owed by officers to the corporation and its stockholders.”); Johnson & Millon, *supra* note 13, at 1601 (“Hardly a week goes by without yet another Delaware decision addressing the subject of director duties. Yet, surprisingly, no Delaware decision has ever clearly articulated the subject of officer duties and judicial standards for reviewing their discharge.”); Shaner, *Restoring the Balance*, *supra* note 13, at 29 (“[T]he exact nature and scope of an officer’s fiduciary obligations were left virtually untouched by the Delaware courts and legislature for almost seventy years, despite Delaware’s otherwise vast and well-developed body of corporate law.”); Sparks & Hamermesh, *supra* note 13, at 215 (“The precise nature of the duties and liabilities of corporate officers who are not directors is a topic that has received little attention from courts and commentators.”).

¹⁰⁷ See, e.g., *Guth v. Loft*, 5 A.2d 503, 510 (Del. 1939) (stating that corporate officers and directors “stand in a fiduciary relation to the corporation and its stockholders”); *McPadden v. Sidhu*, 964 A.2d 1262, 1275 (Del. Ch. 2008) (stating that “an officer owes

to speculate as to the exact nature of their fiduciary duties and what corresponding liability might arise based on broad language and dicta in the courts' opinions.¹⁰⁸ The 2009 Delaware Supreme Court decision in *Gantler v. Stephens* arguably settled the debate when the court explicitly held that "officers of Delaware corporations, like directors, owe fiduciary duties of care and loyalty, and that the fiduciary duties of officers are the same as those of directors."¹⁰⁹ What is surprising is that following the *Gantler* decision (as well as the 2003 amendment of Delaware's personal jurisdiction statute extending jurisdiction over non-resident corporate officers),¹¹⁰ there has continued to be little in the way of developing officer fiduciary duty doctrine. In light of the

to the corporation identical fiduciary duties of care and loyalty as owed by directors"); *Ryan v. Gifford*, 935 A.2d 258, 269 (Del. Ch. 2007) ("The fiduciary duties an officer owes to the corporation 'have been assumed to be identical to those of directors.'" (quoting *In re Walt Disney Co.*, No. CIV.A.15452, 2004 WL 2050138, at *3 (Del. Ch. Sept. 10, 2004))); *In re Walt Disney Co.*, 2004 WL 2050138, at *3 ("To date, the fiduciary duties of officers have been assumed to be identical to those of directors."); see also Shaner, *Restoring the Balance*, *supra* note 13, at 31-34 (discussing the history of fiduciary duties of officers in Delaware).

¹⁰⁸ See Shaner, *Restoring the Balance*, *supra* note 13, at 36 & n.53.

¹⁰⁹ *Gantler v. Stephens*, 965 A.2d 695, 708-09 (Del. 2009). Post-*Gantler*, Delaware Court of Chancery decisions have done little in the way of further developing officer fiduciary duty doctrine. See, e.g., *Hampshire Grp., Ltd. v. Kuttner*, No. CIV.A.3607-VCS, 2010 WL 2739995, at *11 & n.75 (Del. Ch. July 12, 2010) (citing to *Gantler* for fiduciary duty discussion); *ZRII, LLC v. Wellness Acquisition Grp., Inc.*, No. CIV.A.4374-VCP, 2009 WL 2998169, at *11 & n.117 (Del. Ch. Sept. 21, 2009) (same). Further, the court's decision in *Gantler* has been critiqued as still leaving many unresolved issues regarding the exact scope of an officer's fiduciary duties (e.g., whether the standard of the duty of care for officers is negligence or gross negligence), whether the business judgment rule applies to officer decision-making, and the extent of officer liability. See *Johnson & Garvis*, *supra* note 63, at 1108 (discussing the outstanding issues following *Gantler* and stating that "[c]learly the area of officer duties remains murkier than that of director duties"); J. Travis Laster & Steven M. Haas, *Delaware Supreme Court Establishes Clear Rules in Gantler Decision*, *INSIGHTS: CORP. & SEC. L. ADVISOR*, Mar. 2009, at 2, 8 (noting the issues that remain after *Gantler*); Shaner, *Restoring the Balance*, *supra* note 13, at 37-38 ("Even post-*Gantler*, the nature and scope of a corporate officer's fiduciary duties and liabilities are, in some minds, just as unsettled as the *Guth* court left them."); see also R. Franklin Balotti & Megan W. Shaner, *Safe Harbor for Officer Reliance: Comparing the Approaches of the Model Business Corporation Act and Delaware's General Corporation Law*, 74 *LAW & CONTEMP. PROBS.* 161, 167-72 (2011) (discussing whether the protections of Section 141(e) of the Delaware code apply to officers).

¹¹⁰ See DEL CODE ANN. tit. 10, § 3114(b) (2009) (providing for personal jurisdiction over officers of Delaware corporations with respect to all civil actions or proceedings where such officer "is a necessary or proper party, or in any action or proceeding against such officer for violation of a duty in such capacity, whether or not the person continues to serve as such officer at the time suit is commenced").

instances of officer misconduct discussed in Part I, the lack of officer fiduciary duty case law raises questions regarding the effectiveness of the enforcement scheme for holding officers accountable for their fiduciary obligations. Relatedly, while beyond the scope of this paper, to the extent that fiduciary duties continue to be the primary internal governance tool for ensuring an efficient corporate decision-making structure further development of the contours of officer fiduciary duties is necessary.

III. ENFORCEMENT OF OFFICER FIDUCIARY DUTIES

Although we may not be able to change the character of corporate officers, we can change behavior through incentives and penalties. That, in my judgment, could dramatically improve the state of corporate governance.¹¹¹

The corporate scandals described above (and others) have led to doubts as to the effectiveness of fiduciary principles as an adequate check on managerial power.¹¹² This Article posits that it is not necessarily fiduciary duties themselves, but rather the failure to enforce those duties as a constraint on officer power that has contributed to these instances of disloyalty and corruption. The scandals of the twenty-first century reveal persistent misconduct by senior executive officers in violation of their fiduciary obligations.¹¹³ For example, at Enron, fraudulent financial disclosures and conflicted transactions by officers violated their duties of loyalty and care.¹¹⁴ Similarly, in backdating option grants, officers were violating their duties of disclosure.¹¹⁵ Further, the materially misleading financial statements and excessive executive compensation packages, which have been cited as

¹¹¹ Testimony of Chairman Alan Greenspan, *supra* note 10.

¹¹² See Paredes, *Too Much Pay*, *supra* note 4, at 680 (“The scandals, beginning with Enron in 2001, reinforced a continuing concern that many people have: that the United States corporate governance system, especially as in place before the recent spate of reforms, contains inadequate checks and balances to stem managerial disloyalty and corruption.”).

¹¹³ See Sale, *Delaware’s Good Faith*, *supra* note 16, at 461-62 (“Indeed, some of the recent corporate scandals can be tied to governance failures and the inability — or unwillingness — of officer and director fiduciaries to manage faithfully.”).

¹¹⁴ See *supra* notes 71–77 and accompanying text.

¹¹⁵ See *supra* notes 78–82; Lebovitch & Gundersheim, *supra* note 78, at 518-19 (stating that “option backdating cannot happen without an intentionally manipulated process” and that “[t]he practice of stock option backdating often involves the fabrication of corporate records”).

contributing to the financial crisis, are breaches of the duty of care and the duty of loyalty.¹¹⁶ Yet there has been strikingly few breach of fiduciary duty claims based on these events, suggesting that officers' fiduciary duties are not being effectively enforced.¹¹⁷

A. *Why Focus On Enforcement*

Corporate law provides for internal regulation of decision-making through a system of checks and balances on the broad powers and authority provided to the board of directors and, through delegation, the officers. Similar to most regulatory regimes, corporate law provides for standard setting (e.g., fiduciary duties), monitoring to ensure compliance with those standards, and enforcement mechanisms to ensure accountability for failure to comply with those standards.¹¹⁸ In light of the allocation of power and authority between directors and officers on the one hand and stockholders on the other, management accountability for their conduct is particularly important. As Professor Ribstein explained, "The main question regarding corporate governance . . . is whether powerful corporate managers are adequately accountable to shareholders' interests."¹¹⁹ Put more simply by Professor Schwartz, "The separation of control from ownership demands a system of accountability."¹²⁰ Enforcement and accountability go hand in hand as enforcement mechanisms generally provide the means for detecting and punishing failures to discharge legal obligations, which have the corresponding benefit of incentivizing compliance with rules and regulations. Enforcement of fiduciary duties can thus help to decrease

¹¹⁶ See *supra* notes 84–88 and accompanying text.

¹¹⁷ See *supra* notes 106–108 and accompanying text. It should also be noted that until 2003, the Delaware courts lacked personal jurisdiction over non-director officers, thus explaining the lack of litigation surrounding events prior to this time. See 74 Del. Laws 213 (2003) (providing for personal jurisdiction over officers); Johnson & Millon, *supra* note 13, at 1609-18.

Of course breach of fiduciary duty lawsuits are only one way to enforce officer duties. The board of directors, for example, could choose to discipline disloyal officers internally (e.g., firing, demotion). Relatedly, scholars disagree over the relative effectiveness of legal versus non-legal (or extra-legal) sanctions on management behavior. See *supra* note 26. This Article does not attempt to resolve or take a position in this debate although the focus of this Article is mainly on the impact of legal sanctions and the enforcement mechanisms related thereto.

¹¹⁸ See Jason M. Solomon, *New Governance, Preemptive Self-Regulation, and the Blurring of Boundaries in Regulatory Theory and Practice*, 2010 WIS. L. REV. 591, 596.

¹¹⁹ Ribstein, *supra* note 17, at 199; see Paredes, *Too Much Pay*, *supra* note 4, at 688.

¹²⁰ Schwartz, *supra* note 18, at 324.

agency costs and promote efficiency in corporate governance.¹²¹ Accordingly, where effective enforcement is present, the disciplining effect of fiduciary duties should be successful in policing officer conduct.¹²²

As discussed in Part II.B, the exact nature and contours of officers' fiduciary obligations are not yet fully developed. Nonetheless, focusing on the enforcement scheme for those obligations, despite their uncertain status,¹²³ is essential to improving the governance of U.S. corporations. The reasons for this are twofold. First, an effective enforcement system aids (indeed is necessary for) the development of non-director fiduciary duty doctrine. This is due to the nature of fiduciary duties. As a creature of common law, the development of the exact scope and contours of officer fiduciary duties is dependent on the courts being asked to decide lawsuits where violations of those duties are specifically alleged.¹²⁴ The primary mechanism for enforcing officer fiduciary duties is a lawsuit alleging a breach of those duties.¹²⁵ Thus, through effective and actual enforcement (i.e., breach of fiduciary duty claims), the courts will have the opportunity to further expound on

¹²¹ *Id.* at 329. *But see* Daniel R. Fischel & Michael Bradley, *The Role of Liability Rules and the Derivative Suit in Corporate Law: A Theoretical and Empirical Analysis*, 71 CORNELL L. REV. 261, 282 (1986) (concluding that liability rules and their enforcement mechanisms have little impact on management conduct and reducing agency costs).

¹²² *See* Taylor, *supra* note 25, at 1025 (“If [fiduciary] duties were given real content again and courts were willing to insist on compliance with them, perhaps we could begin to stem the flood of improper behavior by corporate management.”).

¹²³ *See supra* Part II.B. The concern that an emphasis on enforcement mechanisms is premature would be that if the exact nature and scope of an officer's fiduciary duties has yet to be defined, then: (i) how can officers know whether they are complying with, or conversely breaching, those duties and is it fair to hold them accountable for ill-defined duties; and (ii) how will the other corporate actors discussed herein know when and how to enforce those duties? One would not, however, anticipate any objection to placing importance on enforcement mechanisms as a general matter. *See* Allen et al., *supra* note 20, at 859-60 (noting the importance of “the presence and integrity of enforcement mechanisms” in corporation law).

¹²⁴ *See In re* Tyson Foods, Inc., No. CIV.A.1106-CC, 2007 WL 2351071, at *1 (Del. Ch. Aug. 15, 2007) (“Judicial restraint suggests that a court should limit itself to the case or controversy placed before it and, to the extent practicable, not engage in speculation about phantasmal parties or issues that might one day appear.”). Alternatively, state legislatures could amend corporate statutes to provide additional guidance on officer fiduciary obligations; however this is unlikely given the enabling nature of corporate law. Even in those jurisdictions where there are statutory provisions that recognize fiduciary duties, the exact contours of those duties are left for the courts to explicate.

¹²⁵ *See* Schwartz, *supra* note 18, at 323-24.

officers' obligations and provide guidance on the conduct expected of these individuals.¹²⁶

Secondly, delaying an analysis of the enforcement scheme for officer fiduciary duties and a discussion of how to improve it until courts fully develop those duties would render those duties empty obligations for the unforeseeable future. As a general matter, actual, effective enforcement is important to ensure compliance with the law.¹²⁷ This means that courts' broad statements that corporate officers owe fiduciary duties will not alone ensure that officers are faithfully discharging those duties. Rather, the current self-regulatory scheme of internal corporate governance through fiduciary obligations will only work if there is actual enforcement.¹²⁸ This is because compliance is a result of officers knowing that they will be held accountable for their fiduciary obligations.

Managerial accountability comes from having effective enforcement mechanisms in place to detect and punish bad behavior. As Professor Cox explained, "[M]uch more is achieved by increasing the detection efforts for misconduct than by increasing the sanction that is imposed for detected misconduct."¹²⁹ Indeed, social scientists have found that this is, in fact, the case. Accountability (which is largely achieved through effective enforcement) can counteract human behavioral

¹²⁶ The relationship of the enforcement of fiduciary duties and the development of those duties is thus, in effect, a circular one. Enforcement of fiduciary obligations through breach of fiduciary duty lawsuits leads to development and clarification of those obligations by the courts. More developed officer fiduciary doctrine then leads to clarity with respect to when officers are and are not complying with their duties, which in turn improves enforcement by providing clarity as to when officers need to be held accountable for their misconduct and breaches of fiduciary duties. Without actual enforcement of officer fiduciary duties in the first place, however, the courts will have no opportunity to develop those duties.

¹²⁷ See Glover, *supra* note 29, at 1142 (noting that "our system of regulation is only as good as the enforcement mechanisms underlying it"); see also TYLER, *supra* note 29, at 3 (referring to the model of human behavior that links legal compliance to the effectiveness of penalties as "instrumentalist").

¹²⁸ As cautioned by Alan Greenspan following the Enron financial scandals, "Unless [officer] responsibilities are enforced with very stiff penalties for non-compliance, as many now recommend, our accounting systems and other elements of corporate governance will function in a less than optimum manner." Testimony of Chairman Alan Greenspan, *supra* note 10 ("Already existing statutes, of course, prohibit corporate fraud and misrepresentation. But even a small increase in the likelihood of large, possibly criminal penalties for egregious behavior of CEOs can have profoundly important effects on all aspects of corporate governance . . .").

¹²⁹ Cox, *supra* note 17, at 2; see *id.* at 9 ("[P]rospect theory suggests that the probability of detection is far more likely to have an impact on agents than will increasing the sanction when there is a very low probability of detection.").

tendencies that undermine self-governance systems and lead to unethical conduct.¹³⁰ In addition, as the certainty of accountability for one's misconduct increases, so does the effectiveness of sanctions in deterring misconduct.¹³¹ Moreover, empirical studies suggest that the most important factor in deterring misconduct is the perceived certainty of detection and punishment.¹³² Accordingly, in order for fiduciary duties to have their intended constraining effect on officer conduct — deterring misconduct and encouraging compliance *ex ante* as well as detecting and sanctioning misconduct *ex post* — it is important that the mechanisms in place to enforce those duties function effectively.

B. *Corporate Actors That Enforce Officer Fiduciary Duties*

There are three different corporate actors that have the ability to directly enforce officers' fiduciary duties: the board of directors, stockholders, and creditors.¹³³ These corporate actors can be classified based on their roles in the corporate enterprise as either internal enforcers or external enforcers. Internal enforcement of officer fiduciary duties comes from the board of directors and the stockholders.¹³⁴ Each of these two groups has direct management rights in the corporate enterprise, albeit to differing degrees. In contrast, external enforcement comes from a corporation's creditors who are not provided with direct management rights and only have enforcement powers in very limited circumstances. The enforcement powers of the board of directors,

¹³⁰ See Quinn & Schlenker, *supra* note 31, at 480.

¹³¹ See Hollinger & Clark, *supra* note 32, at 399.

¹³² See *id.* (noting that “consensus of empirical research is that perceived certainty of punishment is the most effective in shaping behavior”); Sally S. Simpson & Christopher S. Koper, *Deterring Corporate Crime*, 30 *CRIMINOLOGY* 347, 348 (1992) (“Empirical studies . . . suggest . . . that certainty of sanction is more important than severity.”).

¹³³ See *infra* Parts III.B.1–III.B.3.

¹³⁴ One could also include officers themselves as an internal enforcer of officer fiduciary duties. Similar to the board of directors, senior executive officers have a fiduciary obligation to oversee the actions of the officers below them in the corporate hierarchy and report to the board. See *Miller v. U.S. Foodservice, Inc.*, 361 F. Supp. 2d 470, 476-81 (D. Md. 2005); *In re World Health Alts., Inc.*, 385 B.R. 576, 588-92 (Bankr. D. Del. 2008). The problems with the board of directors' enforcement of officer fiduciary duties discussed in Part III.B.1 are equally applicable to the officer's role as an enforcer. In particular, the beholden-ness and imbalance in power is exacerbated when looking at officers enforcing other officers' duties. See Lin, *supra* note 4, at 363-64 (describing the officer deference “inherent in the corporate form,” including with respect to other officers); Paredes, *Too Much Pay*, *supra* note 4, at 722 (“Perhaps the most obvious deferential group is subordinate officers.”). Accordingly, officers are the group that is the least likely to serve as an effective enforcer for their own fiduciary duties.

stockholders, and creditors are not mutually exclusive of each other — with multiple actors having the ability to hold officers accountable for the same breach of fiduciary duty. This Part describes the different enforcement mechanisms available to each corporate actor. In light of persistent officer malfeasance but near absence of fiduciary duty litigation, these corporate actors, as well as the enforcement mechanisms available to them, are not operating effectively as actual constraints on officers who are seemingly motivated to act in their own self-interests. Accordingly, this Part discusses how the development of corporate doctrine coupled with the current dynamic in corporate management undermines the fiduciary enforcement scheme and thus the disciplinary effect of these duties.

1. Board of Directors

The board theoretically permits better monitoring of managers than dispersed shareholders alone can provide.¹³⁵

The board of directors is the corporate actor that is best positioned to enforce officer fiduciary duties. The board plays two roles in the corporation: a manager and a monitor.¹³⁶ By statute, the board is charged with management of the business and affairs of the corporation.¹³⁷ This directive not only encompasses managerial responsibility of the corporation's business, strategy and policy, but also managerial responsibility of the corporation's officers and employees.¹³⁸

¹³⁵ Ribstein, *supra* note 17, at 188-89; *see also* G. Mitu Gulati et al., *Connected Contracts*, 47 UCLA L. REV. 887, 928 (2000). *See generally* Stephen Bainbridge, *The Board of Directors as Nexus of Contracts*, 88 IOWA L. REV. 1, 25-29 (2002) (asserting that the board is the nexus of the corporation); R.H. Coase, *The Nature of the Firm*, 4 ECONOMICA (N.S.) 386 (1937) (offering an economic theory on firms in a specialized exchange economy and highlighting the role of organization in a firm's size).

¹³⁶ *See* Pan, *Rethinking the Board's Duty to Monitor*, *supra* note 17, at 217-25 (discussing these "two complementary roles" of the board).

¹³⁷ *See* DEL. CODE ANN. tit. 8, § 141(a) (2014); *see also* Kaplan v. Peat, Marwick, Mitchell & Co., 540 A.2d 726, 729 (Del. 1988); Grimes v. Donald, No. CIV.A.13358, 1995 WL 54441, at *8 (Del. Ch. Jan. 11, 1995).

¹³⁸ *See* Claire A. Hill & Brett H. McDonnell, *Reconsidering Board Oversight Duties After the Financial Crisis*, 2013 U. ILL. L. REV. 859, 877 (2013) [hereinafter *Reconsidering Board Oversight*] ("One of the canonical roles for boards is to monitor."); Sale, *Monitoring Caremark's Good Faith*, *supra* note 88, at 733 (describing the board as "managers of managers"); *see also* COX & HAZEN, *supra* note 51, at 140 ("Professor Eisenberg suggests that the appropriate aspiration for outside directors be changed to that of evaluating management's stewardship, removing poorly performing managers, and developing and enacting succession plans."); *id.* at 141 ("The overarching principle

This latter responsibility is the board's monitoring role. While the board of directors may (and often does) delegate responsibility for running the day-to-day operations of the corporation to the officers, ultimate control and authority resides with the board.¹³⁹ Accordingly, officers are subject to board oversight and control at all times. The corporate "structure provides monitoring to deal with managerial agency costs and allows for specialization at lower levels of the hierarchy to deal with the vast amounts of information that flow through the large publicly held corporation."¹⁴⁰ As a monitor, the board of directors is charged with ensuring that officers carry out their responsibilities in accordance with the law, which includes their fiduciary duties.¹⁴¹ Stated another way, boards are charged with monitoring responsibilities to ensure that the officers to whom they have delegated management power and authority do not abuse it.¹⁴²

In light of the role officers have played in many corporate scandals, overseeing the actions of these individuals may be the most important function that a board can carry out. Unfortunately, the development of a board's duty of oversight coupled with the disparity in power between the board and officers that exists in the modern corporation, diminishes incentives for earnest monitoring and enforcement. Indeed, it has been repeatedly found that boards of directors have been "unduly passive and

of the [ALI's Corporate Governance Project in the 1980's] is its recognition of the board of directors as a corporate organ that can and should perform a monitoring function, and among other things, to address potential overreaching by management, to replace management if it is not meeting established corporate goals, and to prevent the commission of illegal acts.").

¹³⁹ See *Unanue v. Unanue*, No. 204-N, 2004 WL 5383942, at *15 (Del. Ch. Nov. 9, 2004) ("It is well settled that officers of a corporation serve at the pleasure of the board of directors.").

¹⁴⁰ Ribstein, *supra* note 17, at 197; see also Pan, *Rethinking the Board's Duty to Monitor*, *supra* note 17, at 221 ("Under agency theory, the board is valued for its ability to keep officers in check so that they work in the interests of shareholders."); Sale, *Monitoring Caremark's Good Faith*, *supra* note 88, at 752.

¹⁴¹ See ROBERT CHARLES CLARK, CORPORATE LAW 105-06 (1986); see also Alces, *supra* note 11, at 790 ("Rather than holding senior officers directly responsible for corporate well-being, even though officers control the day-to-day business of the company, Delaware law has long placed primary responsibility with directors, providing that directors are responsible for monitoring officers and so are ultimately responsible for whatever corporate decisions the officers make."); E. Norman Veasey, *The Defining Tension in Corporate Governance in America*, 52 BUS. LAW. 393, 394 (1997).

¹⁴² See Troy A. Paredes, *Enron: The Board, Corporate Governance, and Some Thoughts on the Role of Congress*, in ENRON: CORPORATE FIASCOS AND THEIR IMPLICATIONS 495, 498-99 (Nancy B. Rapoport & Bala G. Dharan eds., 2004) (asserting that officers need to be monitored by directors because otherwise they may be "inclined to shirk or otherwise act in their own self-interest"); Fairfax, *Spare the Rod*, *supra* note 39, at 455.

deferential to the professional managers to whom they had delegated authority for the daily operations of the company,”¹⁴³ many times failing to exercise any meaningful oversight.¹⁴⁴

The contours of a board of directors’ oversight responsibilities were originally set forth in *Graham v. Allis-Chalmers Manufacturing Co.*,¹⁴⁵ and further developed in *In re Caremark International Inc.*¹⁴⁶ In *Caremark*, the Delaware Court of Chancery articulated the standard for determining director liability for failure to oversee a corporation: “only a sustained or systematic failure of the board to exercise oversight — such as an utter failure to attempt to assure a reasonable information and reporting system exists — will establish the lack of good faith that is a necessary condition to liability.”¹⁴⁷ The court acknowledged that the test it articulated for establishing directorial oversight liability was “quite high.”¹⁴⁸

Later decisions of the Delaware courts addressing a board’s monitoring duties have further explained that oversight liability draws heavily upon the concept of directors’ failure to act in good faith.¹⁴⁹ As a result, articulating the “necessary conditions predicate for director

¹⁴³ ABA Report, *supra* note 10, at 128. See generally Myles L. Mace, *Directors: Myth and Reality — Ten Years Later*, 32 RUTGERS L. REV. 293 (1979) (discussing the ineffectiveness of boards of directors).

¹⁴⁴ See 148 CONG. REC. 12,529, 12,532 (2002) (statement of Sen. Carl Levin) (concluding that Enron’s board “knew about numerous questionable practices by Enron management over several years, but it chose to ignore these red flags”); Fairfax, *Spare the Rod*, *supra* note 39, at 399-400 (stating that the events at Enron suggest that “instead of providing a vigorous check on managerial conduct, the directors merely rubber-stamped management’s decisions” and that because they did not perform their oversight functions, this significantly contributed to the corporate governance failures that occurred); Hill & McDonnell, *Reconsidering Board Oversight*, *supra* note 138, at 859-60 (stating that the financial crisis “helps make the case that boards should do more monitoring”); Nees, *supra* note 40, at 237 & n.160 (listing the stockholder derivative suits following the subprime lending/credit crisis that allege breach of fiduciary duty for lack of director oversight).

¹⁴⁵ 182 A.2d 328, 332 (Del. Ch. 1962), *aff’d*, 188 A.2d 125 (Del. 1963).

¹⁴⁶ *In re Caremark Int’l Inc.*, 698 A.2d 959, 971 (Del. Ch. 1996).

¹⁴⁷ *Id.* In the opinion, Chancellor Allen explained that even if the board negligently failed to comply with its oversight obligations it would not be sufficient to establish liability. *Id.*

¹⁴⁸ *Id.*; see also Miller, *supra* note 84, at 84 (“The Delaware courts have thus set a high standard in oversight liability cases, much higher than in ordinary business judgment cases.”).

¹⁴⁹ See, e.g., Stone *ex rel.* AmSouth Bancorporation v. Ritter, 911 A.2d 362, 372 (Del. 2006) (stating that “lack of good faith . . . is a necessary condition to liability”); Desimone v. Barrows, 924 A.2d 908, 940 (Del. Ch. 2007) (stating that lack of good faith must be shown to establish oversight liability).

oversight liability” requires a showing that: “(a) the directors utterly failed to implement any reporting or information system or controls; or (b) having implemented such a system of controls, consciously failed to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention.”¹⁵⁰ In either case, there is essentially a scienter element to establishing directorial liability for violations of a board’s oversight duties.¹⁵¹ To be successful, plaintiffs must prove that the board consciously chose not to discharge its duty to oversee the corporation.¹⁵² As a result, violation of a board’s oversight duty is “possibly the most difficult theory [of liability] in corporation law.”¹⁵³ This narrow standard for liability, especially when combined with the business judgment rule and exculpatory provisions found in almost all corporate charters, has meant that as a practical matter very few breach of oversight claims are successful.¹⁵⁴

¹⁵⁰ *Stone*, 911 A.2d at 370.

¹⁵¹ See Miller, *supra* note 84, at 82-84 (stating that after *Stone v. Ritter*, plaintiffs must show scienter in bringing an oversight claim under *Caremark*); Eric J. Pan, *A Board’s Duty to Monitor*, 54 N.Y.L. SCH. L. REV. 717, 719 (2009/2010) [hereinafter *A Board’s Duty*].

¹⁵² *Stone*, 911 A.2d at 370; see also *Desimone*, 924 A.2d at 935 (stating that “to hold directors liable for a failure in monitoring, the directors have to have acted with a state of mind consistent with a conscious decision to breach their duty of care”).

¹⁵³ *Stone*, 911 A.2d at 372; see also *Guttman v. Huang*, 823 A.2d 492, 505-06 (Del. Ch. 2003) (emphasizing that *Caremark* oversight claims are very difficult to prove); *Caremark*, 698 A.2d at 967; Bainbridge, *Caremark*, *supra* note 84, at 972-78 (discussing *Caremark* and its progeny). Recent decisions of the Delaware courts illustrate the difficulty in bringing these types of claims. See, e.g., *In re Citigroup*, 964 A.2d 106 (Del. Ch. 2009) (dismissing stockholder derivative case alleging that the board failed to properly oversee management before the financial crisis); see also Stephen Bainbridge, *Duties of Corporate Officers and Directors*, PROFESSORBAINBRIDGE.COM (May 3, 2013, 5:07 PM), <http://www.professorbainbridge.com/professorbainbridge.com/2013/05/duties-of-corporate-officers-and-directors.html> (discussing the difficulty in bringing a *Caremark* claim against MF Global’s directors for the misconduct of Jon Corzine).

Many scholars have criticized the development and current formulation of the standard of liability for the duty of oversight, calling for revision of that doctrine. See, e.g., Hill & McDonnell, *Reconsidering Board Oversight*, *supra* note 138, at 859-60 (arguing that boards increase monitoring); Nees, *supra* note 40 (referring to the duty of oversight as a “toothless tiger”); Pan, *Rethinking the Board’s Duty to Monitor*, *supra* note 17, at 210 (criticizing Delaware doctrine as defining the duty of oversight too narrowly); see also Pan, *A Board’s Duty*, *supra* note 151, at 719-20.

¹⁵⁴ See *In re Citigroup*, 964 A.2d at 125 (“The presumption of the business judgment rule, the protection of an exculpatory § 102(b)(7) provision, and the difficulty of proving a *Caremark* claim together function to place an extremely high burden on a plaintiff to state a claim for personal director liability”); see also Hill & McDonnell, *Reconsidering Board Oversight*, *supra* note 138, at 877 (“Most failures that come to mind are passive, not active; thus, not surprisingly, a claim that a board breached its fiduciary duty by failing to monitor almost never succeeds.”).

Director accountability for oversight duties and officers' compliance with their fiduciary obligations are closely intertwined. Current corporate doctrine has created a very narrow range of actions that would trigger director liability for failing to properly (or effectively) monitor.¹⁵⁵ If the board of directors does not have to worry about its oversight obligations being enforced, the result is less incentive to implement robust oversight of the corporation and its officers.¹⁵⁶ In turn, this lack of meaningful oversight means that officers have little to fear in the way of the board monitoring their actions and enforcing their fiduciary duties, resulting in less incentive to comply with those duties. In light of this ripple effect, strengthening the duty of oversight is necessary to reinvigorate the board as an effective enforcer.¹⁵⁷

This discussion focuses primarily on a board's state law fiduciary duty to monitor the corporation's business and affairs, including officers. It is important to note, however, that federal regulation such as Sarbanes-Oxley and Dodd-Frank have emphasized board oversight obligations and led to an increase in the number and use of corporate compliance departments. See Simmons, *supra* note 55, at 1135, 1160 (citing federal regulations under Sarbanes-Oxley and Dodd-Frank as indirect expansions of board oversight responsibilities). The recent federal emphasis on oversight and compliance may counteract some of the problems of a weak fiduciary duty of oversight, the actual impact in improving director monitoring and enforcement of officers. Nevertheless, some scholars have questioned these developments as having limited impact on management oversight and accountability. See, e.g., Fairfax, *Form Over Substance*, *supra* note 91, at 3-4 (asserting that existing federal law does little to alter the legal responsibility of, or expand the scope of legal liability for, corporate management).

¹⁵⁵ See sources cited *supra* note 154 and accompanying text.

¹⁵⁶ See *supra* notes 127-132 and accompanying text (discussing how litigation rates and enforcement mechanisms drive compliance with legal obligations). But see Stephen M. Bainbridge, *Unocal at 20: Director Primacy in Corporate Takeovers*, 31 DEL. J. CORP. L. 769, 826 (2006) ("[T]he tenure and reputation of outside board members are determined by the performance of the top inside managers, which gives independent directors further incentives to be vigilant in overseeing management's conduct."). A weak duty of care under Delaware law also contributes to board deference to executive officers and, relatedly, little oversight. As explained by Professor Paredes:

[O]utside directors face only a slight risk of legal liability under state corporate law for failing to satisfy their responsibility to act with due care, even when they are relatively passive and essentially go along with management's recommendations for the business. Accordingly, there is little upside if directors oppose or even seriously challenge the CEO, and yet there are downside risks for doing so.

Paredes, *Too Much Pay*, *supra* note 4, at 730. See generally Pan, *Rethinking the Board's Duty to Monitor*, *supra* note 17, at 211 (asserting that "the duty to monitor should provide the proper incentives for boards to fulfill this preferred role [as a monitor and manager]").

¹⁵⁷ See also Hill & McDonnell, *Reconsidering Board Oversight*, *supra* note 138, at 878; Pan, *A Board's Duty*, *supra* note 151, at 740 (advocating that Delaware courts should

Further complicating the board's oversight of officer conduct is the imbalance in power that exists in modern corporate management. Delaware corporate law explicitly provides the board of directors with central decision-making power and authority,¹⁵⁸ with officers subject to its authority and control. However, as discussed in Part I, corporate scholars have observed that the director-officer relationship has, in many instances, become reversed.¹⁵⁹ Today, senior executive officers have come to dominate corporate affairs, even being referred to as "the boss[es]" and "monarchs" of the corporation.¹⁶⁰ Correspondingly, boards of directors have been heavily criticized for being "unduly passive and deferential" to the wishes of management.¹⁶¹ The affinity for one another that is created when officers and directors work together (in some instances for many years) can lead to more deference and less oversight and discipline of officers.¹⁶² Even more problematic is that directors' jobs may be at risk (or at least they may feel that they are) because of executive officers' power and influence over the board nomination process.¹⁶³ Further, many directors, even independent

"begin speaking out about the importance of a board's duty to monitor and to back up their exhortations by expanding the scope and application of the duty to monitor in future cases"); Pan, *Rethinking the Board's Duty to Monitor*, *supra* note 17 at 210.

¹⁵⁸ See DEL. CODE ANN. tit. 8, §141(a) (2014); *Kaplan v. Peat, Marwick, Mitchell & Co.*, 540 A.2d 726, 729 (Del. 1988); *Grimes v. Donald*, No. CIV.A.13358, 1995 WL 54441, at *8 (Del. Ch. Jan. 11, 1995).

¹⁵⁹ See *supra* Part I; *supra* notes 143–144; see also Goldberg, *supra* note 62, at F1 (stating that the board has been "relegated to an advisory and legitimizing function"). Evidence of this problem can be found corporations where the chief executive officer is also the chairman of the board. See *Johnson & Millon*, *supra* note 13, at 1617. Excessive executive compensation packages also support the contention that the modern corporation is officer-dominated, not board-run. See Ribstein, *supra* note 17, at 199–200. Moreover, legislation following corporate and financial crises acknowledges that one of the causes of those events was the role reversal in corporate management and thus has sought to increase accountability of officers as well as the directors that should be overseeing the officers. See Shaner, *Restoring the Balance*, *supra* note 13, at 52; see also *Johnson & Millon*, *supra* note 13, at 1614–15 (stating that the "key animating force in recent congressional, SEC, NYSE, and NASDAQ governance reforms" was the "reversal of control" in corporate management).

¹⁶⁰ See Shaner, *Restoring the Balance*, *supra* note 13, at 28 & n.5, 44, 51 (discussing the imbalance in power in corporate management and stating that "[r]ecent corporate scandals illustrat[e] that it is the officers, and not the directors, that are at the center of managing the business and affairs of the corporation").

¹⁶¹ ABA Report, *supra* note 10, at 128. See generally Michelle Harner, *Barriers to Effective Risk Management*, 40 SETON HALL L. REV. 1323, 1356 (2010) (discussing increased risk-seeking behavior among board and officers).

¹⁶² See Lin, *supra* note 4, at 363–72 (describing the organizational and legal deference given to iconic executives); Paredes, *Too Much Pay*, *supra* note 4, at 726–27.

¹⁶³ See Paredes, *Too Much Pay*, *supra* note 4, at 726–27; see also Lin, *supra* note 4, at

directors, are or have been senior executive officers at the same or different corporation. For example, at Wal-Mart Stores, Inc., fifteen of the sixteen directors on its board serve, or have served, as an executive officer at Wal-Mart or another entity, with eleven of those individuals serving as CEOs.¹⁶⁴ These director-officers tend to be more sympathetic to the power and authority of senior management and less likely to monitor these individuals, lest they be monitored themselves in their officer roles.¹⁶⁵ Finally, as compared to officers, directors have time and knowledge limitations in carrying out their duties. This means that directors must rely heavily on the officers to provide them with the information necessary to carry out their duties.¹⁶⁶ In addition, officers typically control the agenda for board meetings.¹⁶⁷ Thus, officers are able to control what the board learns about the corporation and their own conduct, thereby influencing the extent to which they are monitored and held accountable for their fiduciary duties.

363-64 (“[I]conic executives, especially those who are concurrently chief executive officers and chairmen of their corporations, often possess an incredible amount of influence over the selection and composition of their board of directors . . .”).

¹⁶⁴ See *Board of Directors*, WALMART, <http://corporate.walmart.com/our-story/leadership/board-of-directors> (last visited Aug. 5, 2014).

¹⁶⁵ See Alces, *supra* note 11, at 791-92; Ronald J. Gilson & Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STAN. L. REV. 863, 875 (1991) (finding that “[sixty-three] percent of outside directors of public companies are chief executive officers of other public companies”); see also LORSCH & MACIVER, *supra* note 57, at 18-19; Eliezer M. Fich & Lawrence J. White, *CEO Compensation and Turnover: The Effects of Mutually Interlocked Boards*, 38 WAKE FOREST L. REV. 935, 946-51 (2003) (studying the effects of mutual director interlocks and finding “mutually interlocking directorships weaken the monitoring power that the board has over the chief executive”); Johnson & Millon, *supra* note 13, at 1613-14 (describing the director-officer relationship as an “overly cozy” one and asserting that directors feel indebted to senior management).

¹⁶⁶ See Alces, *supra* note 11, at 792 (describing boards as being at an informational disadvantage in monitoring officers); Johnson & Ricca, *Reality Check*, *supra* note 4, at 81 (“Corporate officers are unquestionably better positioned to gain access to corporate information than members of the board of directors.”); Pan, *Rethinking the Board’s Duty to Monitor*, *supra* note 17, at 221-22 (describing officers’ informational monopoly). This informational dependency is particularly problematic for outside, independent directors who generally lack other sources of nonpublic, internal information. See *Report of the American Bar Association Task Force on Corporate Responsibility*, 59 BUS. LAW. 145, 158 (2003) (“Outside directors too often have relied almost exclusively upon senior executive officers, and advisers selected by such officers, for information and guidance about corporate affairs.”). Further, while directors do have statutory informational rights, such information is generally controlled by the corporate officers, and thus subject to their vetting. See, e.g., DEL. CODE ANN. tit. 8, § 220 (2014) (giving directors the right to demand inspection of certain materials).

¹⁶⁷ See Lin, *supra* note 4, at 378-79.

Overall, current oversight and enforcement by the board of directors is limited. Boards lack both the incentive and informational means to monitor officers effectively, let alone rigorously.

2. Stockholders

Liability rules, enforced by shareholder litigation, are theoretically sound and profoundly affect the conduct of corporate managers, at least some aspects of their duties.¹⁶⁸

In exchange for limited personal liability, corporate law provides stockholders with limited direct management rights.¹⁶⁹ However, this does not mean that stockholders do not play an important role as a check on management's power through, in part, the enforcement of fiduciary obligations. Stockholder power in the corporate enterprise has been described as being comprised of three things: the rights to vote, sell, and sue.¹⁷⁰ More specifically, stockholders have the following rights under corporate law that can be used in an effort to monitor and enforce officer duties: bringing direct or derivative lawsuits for breaches of fiduciary duty;¹⁷¹ electing and removing directors,¹⁷² who then appoint, delegate power to, and monitor officers; amending the bylaws of the corporation,¹⁷³ which typically provide for the roles of officers; selling shares of stock in the corporation, which, if enough shares are sold, can then trigger a market response; possessing books and records inspection rights,¹⁷⁴ which aids in gathering information to monitor officer conduct; and accessing federal proxy rules that permit communication with other stockholders through proxy proposals aimed at influencing directors to change corporate policies.¹⁷⁵ These

¹⁶⁸ Schwartz, *supra* note 18, at 323.

¹⁶⁹ See Bainbridge, *The Means and Ends*, *supra* note 2, at 559 (“Shareholders essentially have no power to initiate corporate action and, moreover, are entitled to approve or disapprove only a limited set of board actions.”).

¹⁷⁰ See O'KELLEY & THOMPSON, *supra* note 18, at 157. Stated differently, “[a]ny action by [stockholders] relating to the details of the corporate business is necessarily in the form of an assent, request, or recommendation.” *Cont'l Sec. Co. v. Belmont*, 206 N.Y. 7, 16-17 (1912).

¹⁷¹ See tit. 8, § 327 (2014); DEL. CH. CT. R. 23.1.

¹⁷² See tit. 8, §§ 141(k), 211, 213 (2014).

¹⁷³ See *id.* § 109(a) (2014) (giving the stockholders the power to amend the bylaws); see also *id.* § 142 (2014).

¹⁷⁴ See *id.* § 220 (2014) (books and records inspection rights).

¹⁷⁵ See Shareholder Proposals Rule, 17 C.F.R. § 240.14a-8 (2014).

rights, either individually or in combination, allow stockholders to serve as an independent monitor and enforcer of officer fiduciary duties.

Similar to the enforcement scheme available to the board of directors, the development of corporate doctrine and the corporate management dynamic has limited stockholder monitoring and enforcement powers. The primary enforcement mechanism available to stockholders is the derivative lawsuit.¹⁷⁶ The procedural rules (and corresponding case law) governing stockholders' ability to bring a derivative lawsuit challenging the actions of officers create significant hurdles. These procedural rules have resulted in a process that is expensive, onerous, and has little chance of success in holding officers accountable for their actions.¹⁷⁷ As a result, stockholders can be significantly deterred from using this enforcement mechanism.

Under Delaware law, a stockholder seeking to bring a derivative action based on officer fiduciary duty breaches must first either make a demand on the board of directors to bring a suit on behalf of the corporation or show that making a demand on the board would be futile.¹⁷⁸ In the first scenario, a stockholder must make a demand on the board of directors requesting that the board bring a suit against the

¹⁷⁶ See Nees, *supra* note 40, at 214; Thompson & Sale, *supra* note 18, at 861, 903-04 (describing the role of stockholder litigation as a check on management power). Stockholders may also bring direct claims for officer breaches of fiduciary duty, however the vast majority of breach of fiduciary duty claims against officers will be derivative in nature.

¹⁷⁷ The problematic nature of derivative litigation has been discussed in the context of director accountability. See, e.g., John C. Coffee, Jr. & Donald E. Schwartz, *The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform*, 81 COLUM. L. REV. 261, 326 (1981) (discussing "three distinct barriers" to the effectiveness of derivative actions); Fairfax, *Spare the Rod*, *supra* note 39, at 408-09 (describing procedural hurdles to shareholder actions); Fischel & Bradley, *supra* note 121, at 286 (listing rules that limit the shareholders' ability to bring derivative suits); Rodrigues, *supra* note 4, at 34-35 (describing the difficulties faced in bringing a derivative suit); Ann M. Scarlett, *A Better Approach for Balancing Authority and Accountability in Shareholder Derivative Litigation*, 57 U. KAN. L. REV. 39, 40 (2008) [hereinafter *A Better Approach*] (explaining that "shareholder derivative litigation . . . rarely succeeds in holding directors liable for their actions"); Schwartz, *supra* note 18, at 339-40 (discussing the board's ability to terminate a suit, usually through a special litigation committee).

It has also been noted that stockholder actions under federal securities laws are similarly challenging. See Lin, *supra* note 4, at 369-70.

¹⁷⁸ See DEL. CH. CT. R. 23.1; *In re J.P. Morgan Chase & Co.*, 906 A.2d 808, 819 (Del. Ch. 2005), *aff'd*, 906 A.2d 766 (Del. 2006); *In re eBay, Inc.*, No. CIV.A.19988-NC, 2004 WL 253521, at *2 (Del. Ch. Jan. 23, 2004). The MBCA, in contrast, requires that demand be made on the board of directors in all instances and does not provide for demand excused. MODEL BUS. CORP. ACT § 7.42 (2006).

officer.¹⁷⁹ Whether to pursue the claims in a stockholder's demand is then left to the board's business judgment.¹⁸⁰ As a practical matter, scholars have found that most derivative demand situations result in the board choosing not to sue.¹⁸¹ This is even more likely to be the case when derivative demands involve officers because of corporate management's role reversal — a board that is deferential to its officers is unlikely to pursue stockholder claims against them. Where demand is refused, a stockholder wishing to pursue the litigation must first rebut the business judgment rule presumptions given to the board's decision¹⁸² (a particularly difficult task where, as described below, the board was not involved in the officer's conduct) before even getting to the merits of the breach of fiduciary duty claims. Moreover, scholars have found that in most cases courts defer to a board's decision to refuse a stockholders' derivative demand.¹⁸³

In the second situation — where demand is excused — stockholders must comply with Delaware Chancery Court Rule 23.1 which requires that the complaint allege with particularity the reasons why demand would have been futile.¹⁸⁴ The particularity requirement in Rule 23.1 is a more stringent standard than the notice pleading standard that generally applies.¹⁸⁵ Where a stockholder's complaint fails to allege particularized facts creating a reasonable doubt that: (i) a majority of the board is disinterested and independent; or (ii) the challenged

¹⁷⁹ See *Heineman v. Datapoint Corp.*, 611 A.2d 950, 952 (Del. 1992), *overruled on other grounds* by *Brehm v. Eisner*, 746 A.2d 244, 253 (Del. 2000) (stating that “in the usual case” a stockholder must make a demand on the board to pursue a wrongdoing).

¹⁸⁰ See *Aronson v. Lewis*, 473 A.2d 805, 813 (Del. 1984), *overruled on other grounds* by *Brehm*, 746 A.2d at 253.

¹⁸¹ See Carol B. Swanson, *Juggling Shareholder Rights and Strike Suits in Derivative Litigation: The ALI Drops the Ball*, 77 MINN. L. REV. 1339, 1350 & n.60 (1993) [hereinafter *Juggling Shareholder Rights*].

¹⁸² See *Zapata Corp. v. Maldonado*, 430 A.2d 779, 784 & n.10 (1981) (“Consistent with the purpose of requiring a demand, a board decision to cause a derivative suit to be dismissed as detrimental to the company, after demand has been made and refused, will be respected unless it was wrongful.”).

¹⁸³ See Swanson, *Juggling Shareholder Rights*, *supra* note 181, at 1350.

¹⁸⁴ DEL. CH. CT. R. 23.1; see *Aronson*, 473 A.2d at 814-15.

¹⁸⁵ See BALOTTI & FINKELSTEIN, *supra* note 47, § 13.12; see also *Grobow v. Perot*, 539 A.2d 180, 187 (Del. 1988) (stating that in considering a derivative complaint “upon a motion to dismiss, only well-pleaded allegations of fact must be accepted as true; conclusionary allegations of fact or law not supported by allegations of specific fact may not be taken as true”), *overruled on other grounds* by *Brehm*, 746 A.2d at 253; *In re Nat'l Auto Credit, Inc.*, No. CIV.A.19028, 2003 WL 139768, at *12 n.69 (Del. Ch. Jan. 10, 2003) (stating that the standard under Rule 23.1 is more rigorous than under Rule 12(b)(6)).

decision was a valid exercise of business judgment, the court will dismiss the complaint even if the underlying breach of fiduciary duty claims against the officer are otherwise meritorious.¹⁸⁶ Successfully pleading demand futility is even more difficult where the actions involve officer conduct and not conduct of the directors who would be considering the demand.¹⁸⁷ Adding to stockholders' challenging task is that there are generally no discovery rights to assist them in demonstrating demand futility.¹⁸⁸

Finally, even in those few demand excused cases that survive a Rule 23.1 motion to dismiss, the board can appoint a special committee of independent directors to investigate and, if it chooses, to dismiss, settle, or litigate the allegations.¹⁸⁹ As in the demand refused context, most special litigation committees recommend dismissal.¹⁹⁰ In reviewing a special litigation committee's recommendation and board's decision to dismiss the complaint, courts are again generally deferential and grant the motion to dismiss.¹⁹¹

¹⁸⁶ See *Brehm*, 746 A.2d at 253; *Aronson*, 473 A.2d at 814-15.

¹⁸⁷ Under *Rales v. Blasband*, where the action(s) being challenged by a stockholder were not taken by the board, such as officer breaches of fiduciary duty, the test for determining whether demand is excused is "whether or not the particularized factual allegations of a derivative stockholder complaint create a reasonable doubt that, as of the time the complaint is filed, the board of directors could have properly exercised its independent and disinterested business judgment in responding to a demand." 634 A.2d 927, 934 (Del. 1993). Where a stockholder complaint is alleging breaches of fiduciary duty based on officer, and not director, conduct, it will be particularly difficult to show futility. Further, even where there is an apparent role reversal in a corporation's management, more than just deferential board behavior, but rather the inability to exercise independent judgment by a majority of the directors must be shown to satisfy the test under *Rales*. See *Aronson*, 473 A.2d at 816 (stating that "[t]he shorthand shibboleth of 'dominated and controlled directors' is insufficient" to excuse demand); *Orman v. Cullman*, 794 A.2d 5, 27 (Del. Ch. 2002) (allegations of long-standing profession or personal relationships, without more, are insufficient to support a claim of control); *BALOTTI & FINKELSTEIN*, *supra* note 47, at § 13.14[B] ("[A]n unsupported allegation of domination and control of directors by one interested in the transaction is insufficient to demonstrate demand futility.").

¹⁸⁸ This is why most courts emphasize stockholders' Section 220 books and records rights in investigating and pleading demand futility. See *Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart*, 845 A.2d 1040, 1056-57 (Del. 2004).

¹⁸⁹ See *Zapata Corp. v. Maldonado*, 430 A.2d 779, 786-87 (Del. 1981).

¹⁹⁰ See *Fairfax*, *Spare the Rod*, *supra* note 39, at 409.

¹⁹¹ See *Swanson*, *Juggling Shareholder Rights*, *supra* note 181, at 1357-58 ("Management's use of this device has motivated courts to . . . defer to the committee's determination more often."); see also *Zapata*, 430 A.2d at 784 ("[A] board decision . . . will be respected unless it was wrongful."); Carol B. Swanson, *Corporate Governance: Sliding Seamlessly into the Twenty-First Century*, 21 J. CORP. L. 417, 437 (1996) [hereinafter *Corporate Governance*]. The Delaware Supreme Court's decision in *Zapata*

As a general matter, enforcement process drives enforcement behavior. In either scenario described above — demand refused or demand excused — the derivative lawsuit process is complex, lengthy, expensive (with any recovery going to the corporation and not the stockholder), and ultimately difficult to successfully pursue, thereby deterring its use as an enforcement tool.¹⁹² Further undermining the disciplinary effect of derivative lawsuits are business judgment rule deference (to the extent it is found to apply to officers), Directors and Officers Insurance (“D&O Insurance”), indemnification, and advancement, which allow officers to avoid accountability for their misconduct.¹⁹³ The overall effect then is a de-emphasis of the role of legal liability in constraining managerial behavior.¹⁹⁴

In addition to the derivative lawsuit process, stockholders face other problems in operating as monitors and enforcers of officer duties. First is the collection action problem that occurs in corporations that have a large, diverse stockholder base.

During much of the last century, scholars and others have observed that an effect of large capital markets and shareholder diversification has been to create a largely passive class of capital investors. In most large-scale organizations, economic logic foreclosed these investors from closely supervising the managerial agents whose expertise and access to information

Corp. v. Maldonado provides a two-part test to determine whether to grant a motion to dismiss based on the findings of the special litigation committee: (1) a review of the committee’s independence and good faith and the basis for its decision; (2) whether in the court’s “own independent business judgment,” taking into consideration issues of law, public policy and the corporation’s best interest, it agrees with dismissing the action. 430 A.2d at 789.

¹⁹² *But see* Scarlett, *A Better Approach*, *supra* note 177, at 40 (“Yet, litigation remains a device commonly employed by shareholders when boards of directors abuse their power. Recent shareholder derivative actions against Apple, Citigroup, Tyson Foods, Walt Disney, and Enron, among others, demonstrate that judicial recourse remains a powerful tool used by shareholders.”).

¹⁹³ Scholars have discussed how these mechanisms have eliminated directors’ exposure to liability for breaches of fiduciary duty. *See* Fairfax, *Spare the Rod*, *supra* note 39, at 409-14; Fischel & Bradley, *supra* note 121, at 286; Scarlett, *A Better Approach*, *supra* note 177, at 40; *see also* Jones, *supra* note 17, at 116-17 (citing indemnification, exculpation, and insurance as protections for directors from monetary liability from a stockholder lawsuit). *But see* Schwartz, *supra* note 18, at 334.

¹⁹⁴ *Cf.* Fischel & Bradley, *supra* note 121, at 286 (discussing the effect of derivative lawsuit requirements on directorial liability).

enabled the agents to operate these large firms more effectively.¹⁹⁵

While the emergence of institutional and activist stockholders has been cited as overcoming the collective action problem, the lack of economic incentives and other time, money and resource constraints continue to deter individual, institutional, and activist stockholders alike from engaging in consistent, meaningful monitoring of management.¹⁹⁶

¹⁹⁵ Allen et al., *supra* note 20, at 860-61 (noting that regulation of the national securities markets was one way to instill confidence in shareholders investing in corporations). *But see* Ronald J. Gilson & Jeffrey N. Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights*, 113 COLUM. L. REV. 863, 863 (2013) (“Equity ownership in the United States no longer reflects the dispersed share ownership of the canonical Berle-Means firm.”).

¹⁹⁶ *See, e.g.*, Bainbridge, *Shareholder Disempowerment*, *supra* note 2, at 1751-54 (arguing that investors lack either the ability or motivation to engage in monitoring); Lin, *supra* note 4, at 367-68 (finding that “economic factors simply do not incentivize many individual shareholders to try to actively engage in corporate governance” and institutional stockholders also face constraints on activism and monitoring); Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 GEO. L.J. 445, 446, 473-74 (1991) (finding “precious few incentives” for institutional investors to engage in corporate governance activities). *But see* Lucian A. Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833, 876-79 (2005) [hereinafter *The Case*]; Gilson & Gordon, *supra* note 195, at 867-68, 896-902.

The emergence of the institutional and activist stockholders as active participants in corporate governance has compensated for some of the collective action problem. *See* O’KELLEY & THOMPSON, *supra* note 18, at 214-15, 223 (noting the “unprecedented growth in activism and institutional shareholders”); Gilson & Gordon, *supra* note 195, at 867-68 (describing the interplay of institutional and activist stockholders in influencing corporate governance). Institutional investors, because of their large ownership percentages, can overcome the problem of collective action in influencing corporate governance. Further, institutional investors tend to be more knowledgeable than individual stockholders and are less likely to be able to take advantage of selling their stock when they become frustrated with corporate management. This means that institutional stockholders tend to be better positioned and have more of an incentive to carry out the traditional role envisioned for stockholders — monitoring and enforcing board and officer conduct and engaging management in a conversation about how the corporation should be run. *See* O’KELLEY & THOMPSON, *supra* note 18, at 214-16; Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811, 834-39 (1992); Gilson & Kraakman, *supra* note 165, at 867-68. There are of course concerns that arise when you begin to talk about the role of institutional stockholders. *See, e.g.*, Black, *supra*, at 862 (discussing institutional myopia); John C. Coffee, Jr., *Liquidity versus Control: The Institutional Investor as Corporate Monitor*, 91 COLUM. L. REV. 1277, 1352-53 (1991) (stating that institutional investors will remain passive); John C. Coffee, Jr., *The Future as History: The Prospects for Global Convergence in Corporate Governance and Its Implications*, 93 NW. U. L. REV. 641, 661-62 (1999) (describing the problems with large block stockholders).

Related to the collective action issue is the ability of stockholders to freely enter and exit a corporation. While a stockholder's ability to sell his/her shares when he/she disagrees with corporation management can, through the market's reaction thereto, influence corporate management in a disciplining manner,¹⁹⁷ it also results in what has been described as "rational apathy."¹⁹⁸ As former Chairman of the Federal Reserve Alan Greenspan explained:

A related, but separate, issue is that shareholders must perceive that corporate governance is properly structured so that financial gains are fairly negotiated between existing shareholders and corporate officeholders. Shareholding is now predominately for investment, not corporate control. Our vast and highly liquid financial markets enable large institutional shareholders to sell their shares when they perceive inadequacies of corporate governance, rather than fix them.¹⁹⁹

As a result, the nature of corporate ownership in public entities — free transferability — results in more of a disincentive for stockholders to police officer conduct.

¹⁹⁷ See Ribstein, *supra* note 17, at 189 ("Free transferability of management rights [by stockholders] is important to the development of a market for control, which provides effective monitoring of managers."). The ability to sell ownership in a corporation functioning as an enforcement mechanism assumes that: (i) market pressures will result in good conduct by management; and (ii) the market for control operates efficiently, which, scholars have pointed out, in reality may not be the case. See, e.g., Mark R. Huson et al., *Internal Monitoring Mechanisms and CEO Turnover: A Long-Term Perspective*, 56 J. FIN. 2265, 2294-96 (2001) (finding that evidence does not fully support "the theory that a more active takeover market strengthens internal control mechanisms"); see also Lucian A. Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. 1435, 1462-70 (1992); William W. Bratton, *The Economic Structure of the Post-Contractual Corporation*, 87 NW. U. L. REV. 180, 195-96 (1992) (asserting that anti-takeover doctrine has weakened the threat of a takeover and the corresponding disciplinary effect of a market for corporate control); Victor Brudney, *Corporate Governance, Agency Costs, and the Rhetoric of Contract*, 85 COLUM. L. REV. 1403, 1420-29 (1985) (discussing why market constraints on management behavior are ineffective); Gordon, *supra* note 10, at 1235 (noting that the events surrounding Enron's collapse "provide[] another set of reasons to question the strength of the efficient market hypothesis"); Jones, *supra* note 17, at 118 (critiquing the enforcement role of markets for failing to provide ample accountability).

¹⁹⁸ O'KELLEY & THOMPSON, *supra* note 18, at 213.

¹⁹⁹ Testimony of Chairman Alan Greenspan, *supra* note 10. This statement by Chairman Greenspan was made right before the adoption of Sarbanes-Oxley, which led to significant corporate governance changes aimed at, in part, this problem. The problem of rational apathy still exists today. See O'KELLEY & THOMPSON, *supra* note 18, at 213-14.

A third shortcoming in stockholders' ability to effectively monitor and enforce officer fiduciary duties is an informational one. As was noted above, because officers are involved in running the day-to-day operations of the corporation, they effectively have a monopoly on the flow of information to the board and the stockholders.²⁰⁰ Indeed, much of the information that is provided to stockholders is created by officers, or produced at their direction or under their supervision.²⁰¹ While there are informational protections available to stockholders that provide the ability to gain access to inside information, such as state statutes providing for books and records inspection rights²⁰² and federal rules requiring public corporations to make certain filings public (e.g., quarterly and annual reports),²⁰³ these rights have their limitations and do not ensure full and honest disclosure by corporate management.²⁰⁴ Thus, like the board of directors, stockholders are at an informational disadvantage that seriously weakens their ability to monitor officer conduct and ensure compliance with fiduciary obligations.²⁰⁵

Finally, stockholders can try to use their management rights to indirectly influence officer behavior and fiduciary duty enforcement via the board of directors (e.g., director election and removal rights, proxy proposals, derivative lawsuits alleging breach of board oversight duties).²⁰⁶ Indirect enforcement of officer conduct, however, assumes that the board is functioning as an active and independent monitor. As discussed above, there are problems in the current formulation of the duty of oversight and concerns with respect to the board's power and authority relative to that of senior executive officers. These

²⁰⁰ See *supra* notes 166–167 and accompanying text.

²⁰¹ See Johnson & Ricca, *Reality Check*, *supra* note 4, at 82.

²⁰² See, e.g., DEL. CODE ANN. tit. 8, § 220 (2014) (providing stockholders with the right to inspect and make copies of the corporation's stock ledger, list of stockholders, and other books and records).

²⁰³ See, e.g., Securities and Exchange Act of 1934, 15 U.S.C. § 78m (prescribing annual and quarterly reports).

²⁰⁴ Stockholders do not have a right to unfettered access to corporation information. For example, under section 220 of the Delaware Code, stockholders' right to inspect the books and records of the corporation is tempered by a "proper purpose" requirement. See tit. 8, § 220. Additionally, "[w]hile public corporations make periodic material disclosures to the public through securities filings to inform investors and regulators, such disclosures may be incomprehensible, incomplete, or nonexistent." Lin, *supra* note 4, at 366.

²⁰⁵ An emphasis on officers' internal duty of disclosure has been proposed as a way to remedy this problem. See German, *supra* note 78 at 255.

²⁰⁶ See Bainbridge, *The Means and Ends*, *supra* note 2, at 568 & 568 n.101.

considerations thus impact stockholder influence on the board's ability to effectively monitor and enforce officer duties.²⁰⁷

In sum, without reform to the enforcement mechanisms available to stockholders, they will continue to be incapable of functioning as a meaningful check on officer and director conduct.

3. Creditors

Traditional approaches to corporate governance focus exclusively on shareholders and neglect the large and growing role of creditors.²⁰⁸

Creditors can obtain direct or indirect oversight rights and exert their influence over the corporation, the board and officers. The primary way creditors acquire this power is through contractual rights. For instance, creditors may include specific management-like rights in contracts, such as veto power over certain corporate decisions or actions.²⁰⁹ Creditors also "often use the declaration of default threat to influence officers' and directors' decisions."²¹⁰ However, with respect to directly enforcing officers' fiduciary duties, creditors play a limited role. This is because fiduciary duties are owed to the corporation and its stockholders, not creditors or any other outside party.²¹¹ The exception

²⁰⁷ See *supra* Part III.B.1. A further assumption underlying stockholders' indirect enforcement powers is that stockholders actually influence the board through the use of their election and removal powers. In reality, however, scholars have found that this does not appear to be the case. See Harry DeAngelo & Linda DeAngelo, *Proxy Contests and the Governance of Publicly Held Corporations*, 23 J. FIN. ECON. 29, 30 (1989) (finding that dissident stockholders only succeed in winning a board seat one-third of the time when challenging officer-recommended directors); see also Steven A. Ramirez, *The End of Corporate Governance Law: Optimizing Regulatory Structures for a Race to the Top*, 24 YALE J. ON REG. 313, 349 (2007) ("CEOs are simply better organized and have superior economic and political resources than the investing public."); Ribstein, *supra* note 17, at 199-200 (stating that "shareholders' powers to approve manager-initiated actions and to remove the directors may not be adequate to police agency costs").

²⁰⁸ Baird & Rasmussen, *supra* note 17, at 1209.

²⁰⁹ See Gulati et al., *supra* note 135, at 920.

²¹⁰ Alces, *supra* note 11, at 784; see Baird & Rasmussen, *supra* note 17, at 1229. Creditor protection laws also provide creditors with limited rights separate and apart from contractual and fiduciary duties.

²¹¹ See *N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla*, 930 A.2d 92, 99-101 (Del. 2007) (making clear that fiduciary duties run to the corporation and its stockholders, not creditors); BALOTTI & FINKELSTEIN, *supra* note 47, § 4.14. While the cases addressing to whom fiduciary duties are owed occur in the director context, it is fair to assume given the Delaware Supreme Court's language in *Gantler v. Stephens* that this proposition is equally true for officers. See 965 A.2d 695, 708-09 (Del. 2009).

to this general rule is that once a corporation falls within the zone of insolvency, creditors can bring derivative, but not direct, claims for breach of fiduciary duty.²¹² Importantly, even in the zone of insolvency, fiduciary duties are not owed to creditors; they are only owed to the corporate enterprise.²¹³

Creditors' role as an enforcer of officer fiduciary duties is more problematic than that of the board or the stockholders.²¹⁴ First, creditors only have the ability to enforce fiduciary obligations after officers have engaged in egregious or prolonged misconduct that (likely) has resulted in the corporation being in poor shape (i.e., in the zone of insolvency). Second, the only fiduciary enforcement mechanism available to creditors is the derivative lawsuit. As was discussed in Part III.B.2 with respect to stockholders, the development of derivative litigation requirements has led to an onerous and expensive process that disincentivizes its use.²¹⁵ Further, any recovery in a derivative lawsuit goes to the corporation, and not the creditors, lessening the financial incentive to engage in such litigation.²¹⁶ Finally, creditors have limited access to corporate information to use in detecting and disciplining officer malfeasance. Similar to stockholders, creditors do not have general access to inside information. Unlike stockholders, however, creditors are not provided with statutory informational rights.²¹⁷ As a result, creditors must rely primarily on publicly available materials that

²¹² See *Gheewalla*, 930 A.2d 92, 101-02.

²¹³ See *id.* at 101-03 (“When a solvent corporation is navigating in the zone of insolvency, the focus for Delaware directors does not change: directors must continue to discharge their fiduciary duties to the corporation and its shareholders by exercising their business judgment in the best interests of the corporation for the benefit of its shareholder owners.”).

²¹⁴ See *id.* at 99-103 (stating that fiduciary duties and the right to enforce those duties only extend to creditors when a corporation is in the zone of insolvency and not at any other time). To the extent that creditors seek to protect themselves from officer malfeasance by providing themselves with oversight and enforcement powers in their contracts with the corporation, this too is problematic. Contractual protection means that creditors must anticipate, *ex ante*, officers' misconduct and what oversight or informational rights they will need to effectively detect and then hold officers (or more likely the corporation) accountable for that conduct. This is a difficult and costly endeavor, and one that can easily deter creditors. Even where creditors do negotiate for contractual oversight and enforcement powers, they will be tailored only to protect the creditors' interests. This contractual enforcement power is then of limited value in that it does not necessarily protect the corporate enterprise, the stockholders, or the market and economy more broadly from officer misconduct.

²¹⁵ See *supra* Part III.B.2.

²¹⁶ See *Joy v. North*, 692 F.2d 880, 886-87 (2d Cir. 1982).

²¹⁷ Section 220 of the Delaware Code only provides books and records rights to directors and stockholders of a corporation. See DEL. CODE ANN. tit. 8, § 220 (2014).

are largely officer-controlled and officer-vetted, content-wise.²¹⁸ Accordingly, fiduciary enforcement is a difficult and costly endeavor that can easily dissuade creditors from taking action.

IV. STRENGTHENING ENFORCEMENT

The many recent examples of officer malfeasance, along with how very few cases address their actions, suggest that the existing legal enforcement scheme does not promote (and indeed may hinder) officers' accountability for their conduct. Yet many scholars agree that formal accountability is essential to preventing unnecessary errors, irresponsibility, self-dealing, and other abuses of the power bestowed on corporate management.²¹⁹ At the outset, it should be recognized that this corporate governance problem is a multifaceted one with the under-enforcement of officer fiduciary duties being just one piece, albeit a very important one. Generally, no one solution can remedy a complex problem, and this is particularly true in the corporate law context. Corporations vary widely in their size (whether measured in terms of finance, personnel, or otherwise), capitalization structure (including publicly-traded versus private corporations), management structure, industry, business model, and other attributes.²²⁰ Moreover, "[b]ecause corporate governance requires balancing the benefits of delegation and hierarchy against the need for accountability, no single solution is likely to work for every firm."²²¹ This Part attempts to tackle part of the accountability problem by proposing corrections to incentivize

²¹⁸ See sources cited *supra* notes 202–207.

²¹⁹ See, e.g., Stephen M. Bainbridge, *The Business Judgment Rule as Abstention Doctrine*, 57 VAND. L. REV. 83, 107-08 (2004) [hereinafter *The Business Judgment Rule*] (noting that unaccountable authority leads to unnecessary errors); Fairfax, *Spare the Rod*, *supra* note 39, at 394-95 (asserting that "legal liability can curb directors' irresponsibility and the abuses that result from that irresponsibility"); Scarlett, *A Better Approach*, *supra* note 177, at 65 (noting that unaccountable authority may not be sufficient to prevent self-dealing, negligence, and mistakes); Schwartz, *supra* note 18, at 324 (asserting that because of the separation of ownership from control in the corporation, managers must be subject to certain constraints and a system of accountability). Even Professor Bainbridge, who advocates for board primacy in the corporate structure, has stated that "unaccountable authority may be exercised opportunistically" and can lead to careless conduct. Bainbridge, *The Business Judgment Rule*, *supra*, at 107-08. This opportunistic behavior includes "intentional self-dealing," as well as "forms of 'shirking'" like "negligence, oversight, incapacity, and even honest mistakes." *Id.* But see sources cited *supra* note 26 and accompanying text (discussing extra-legal forces and sanctions as a means of influencing management behavior).

²²⁰ See Statement of Comm'r Troy Paredes, *supra* note 18.

²²¹ Ribstein, *supra* note 17, at 201.

enforcement of officer fiduciary duties and, correspondingly, incentivize officers' compliance with those duties.

To be successful in restoring the fiduciary system of checks and balances that constrain officers and protect stockholders against self-interested behavior, it is important to be mindful of the corporate form and its structure. Following the financial crisis, the Task Force of the ABA Section of Business Law cautioned policymakers that any reform should "seek to formulate realistic responses that take into account the roles of managers, boards, and shareholders in the corporate governance system."²²² The internal governance of a corporation is set up as a self-regulatory scheme that will only work if enforcement mechanisms are used effectively.²²³ Accordingly, reform in this area of the law needs to largely focus on inside corporate actors (i.e., the board and stockholders), as opposed to outside actors (i.e., creditors).²²⁴ An emphasis on enforcement by the board and stockholders has the benefit of involving two groups of corporate actors that have a substantial interest in what they are regulating — the corporation and its business.²²⁵ Internal enforcement can also be more responsive to the

²²² *ABA Report*, *supra* note 10, at 113; *see also id.* at 110 ("[We should] avoid[] reforms that are insensitive to positive aspects of the present legal ordering of decision rights and responsibilities within the corporation. Maintaining an appropriate balance between responsibilities for corporate oversight and decision-making is critical to the corporation's capacity to serve as an engine of economic growth, job creation, and innovation.").

²²³ *See* sources cited *supra* notes 29–33 and accompanying text.

²²⁴ This does not, however, mean that outside enforcement of officer fiduciary duties would not aid in correcting some of the problems in corporate governance. Indeed, a focus only on internal enforcement mechanisms would be too narrow. External regulation can also supplement and reinforce internal governance mechanisms to achieve an overall effective enforcement scheme.

Emphasizing internal corporate structures and regulation to accomplish governance reform is not a new proposition. *See, e.g.*, Rodrigues, *supra* note 4 (discussing internal versus external regulation); Simmons, *supra* note 55 (advocating for internal regulation). In addition, some of the cited drawbacks of external corporate regulation include the higher costs for market or governmental enforcement, the limits to the efficacy of external regulation, the lack of information and institution-specific knowledge, the short-term interests of regulators and policymakers, and limited government resources. *See* Fairfax, *Spare the Rod*, *supra* note 39, at 433-43; Rodrigues, *supra* note 4, at 22-23; Simmons, *supra* note 55, at 1134-35, 1155.

²²⁵ *See* Aviram, *supra* note 13, at 777 ("[A] beneficiary [such as the board of directors] has a stronger incentive to accurately assess the actor's actions, since its fortunes (but not a judge's) rise and fall as a result of these actions."). The rationale for entity liability for management misconduct further supports internal regulation of officer duties: "[E]ntity liability conscripts the entity's resources to the deterrence of its agents' misconduct. The corporation's conscription is especially appropriate because its relationship to its agents provides both the authority and the power to influence their

complexities in corporate management and have the greatest impact on the deterrence and accountability effect of fiduciary duties on officers. Other reasons to focus on enforcement by these inside actors, (as opposed to outside regulators) include more continuous relationship with the corporation, more substantive participation in the management of the corporation, greater access to information, greater institutional knowledge, and better positioning to monitor and enforce officer duties.²²⁶

Finally, each inside corporate actor cannot always function as a strong policing body for officer behavior.²²⁷ For example, the board of directors is better positioned and may have a better perspective than stockholders (who are technically external to the corporation) in monitoring and disciplining officer conduct. Meaningful board oversight and enforcement is also necessary for reinforcing the ex ante power of fiduciary duties because stockholder enforcement, by its very nature, will always be ex post disciplining for breaches of those duties.²²⁸ Conversely, a corporation's stockholders may at times be better positioned to monitor and enforce officer fiduciary duties. This is particularly true where a board is dominated by, or overly deferential to, the senior executive officers, resulting in ineffective board supervision. In such a situation, judicial oversight and enforcement through a stockholder's derivative lawsuit is optimal.²²⁹ Indeed, the purpose of the derivative lawsuit, as the primary enforcement mechanism available to stockholders, is to enable stockholders to enforce corporate rights (such as fiduciary obligations) where the corporation refuses to do so. In those instances where those that should bring suit and enforce duties (i.e., the board) fail to do so, the stockholders have the ability to protect themselves and the

behavior." Cox, *supra* note 17, at 9.

²²⁶ See ABA Report, *supra* note 10, at 134 ("Meaningful shareholder oversight — as with board oversight of management — requires, however, the application of company-specific judgment and consideration of the interests of the corporation and its entire shareholding body."); Aviram, *supra* note 13, at 777.

²²⁷ See ABA Report, *supra* note 10, at 146 ("Effective corporate governance also requires respect for the distinct roles of shareholders and boards in corporate decision-making."); cf. Michael C. Dorf, *After Bureaucracy*, 71 U. CHI. L. REV. 1245, 1269 (2004) ("[N]o one [constituency] has a complete solution to what collectively ails them.").

²²⁸ See Aviram, *supra* note 13, at 777 ("Beneficiary oversight is also superior when a challenged action would benefit more from ex ante review (which the beneficiary can provide) than from ex post review (which is what judicial oversight provides).").

²²⁹ See *id.* at 777-79 (discussing when judicial oversight is superior to beneficiary (e.g., board) oversight).

corporation.²³⁰ Stockholders also play an important role because they may have different risk preferences and interests in the corporation than the board, which could influence enforcement actions. Accordingly, each of the board of directors and the stockholders would need a tailored correction to incentivize enforcement action and the corresponding monitoring duties necessary for effective enforcement.

A. *Focusing on Stockholders*

In proposing corrections to the enforcement scheme for officer fiduciary duties, this Article's primary focus is on reevaluating derivative litigation burdens in an effort to ensure stockholders have a meaningful enforcement mechanism. There are several reasons why a discussion of enforcement reform should begin with focusing on stockholders. First, reform of derivative litigation requirements is aimed at restoring substance to one of the basic powers provided to stockholders — the ability to sue.²³¹ In discussing one of stockholders' other fundamental powers — the right to vote — courts have made clear that this right is “critical to the theory that legitimates the exercise of power . . . by some (directors and officers) over vast aggregations of property that they do not own.”²³² The ability to sue is similarly critical in that it provides stockholders with a means of self-help in protecting their interests in the corporation where the directors and officers fail to do so.

Secondly, stockholders have the ability to enforce both officer and director compliance with their respective fiduciary obligations. This means that the proposed reform discussed herein would have the dual benefit of strengthening stockholders' ability to enforce fiduciary duties at the officer level and the board level. In addition to providing stockholders with a meaningful mechanism for direct enforcement of officer duties, stockholders would also be able to seek to hold officers accountable through the indirect mechanisms of holding directors responsible for their duty of oversight, which has the benefit of incentivizing board monitoring of officer conduct.

Finally, the proposed reforms aimed at incentivizing stockholder enforcement are less invasive to the present legal ordering and duties in

²³⁰ See *Kramer v. W. Pac. Indus., Inc.*, 546 A.2d 348, 351 (Del. 1988); *Taormina v. Taormina Corp.*, 78 A.2d 473, 475-76 (Del. Ch. 1951).

²³¹ See *supra* note 170 and accompanying text (describing the powers of stockholders as being comprised of the right to vote, sell, and sue).

²³² *Blasius Indus., Inc. v. Atlas Corp.*, 564 A.2d 651, 659 (Del. Ch. 1988).

corporate law.²³³ Corrections to the enforcement scheme at the board level involve reforming aspects of the duty of oversight. Historically, courts are cautious in making significant doctrinal shifts in fiduciary duties, in particular where, as would be the case here, such changes would lead to an increase in director liability exposure.²³⁴ Moreover, changes to directors' oversight responsibility will potentially affect the fundamental workings of the corporation. In contrast, revising derivative litigation burdens would be a more modest reform aimed at the enforcement, not the content, of fiduciary obligations. Additionally, any reform of the duty of oversight that does not also (or first) address derivative litigation reform would be undermined in that even if directors owed a more robust oversight duty, the procedural hurdles discussed in Part III.B.2 would hinder stockholder enforcement of such duty. As a result, reform at the stockholder level is likely more achievable and would have an immediate impact.

B. *Reevaluating Derivative Litigation Burdens*

As discussed in Part III.B.2, the enforcement mechanisms available to stockholders deter actual enforcement behavior and/or fail to provide the tools to influence corporate governance. First and foremost among the deficiencies is the development of the procedural requirements surrounding derivative litigation. Stockholders, whether small household investors or large institutional investors, still remain distant from frequent exercise of their governance rights. As described in the Report of the Task Force of the ABA Section of Business Law Corporate Governance Committee on Delineation of Governance Roles and Responsibilities, “[m]uch of the current discussion of shareholder rights and tensions regarding shareholder efforts to influence corporate behavior result from perceived inadequacies of these devices in

²³³ See ABA Report, *supra* note 10, at 149 (“Reforms designed to strengthen the long-term orientation of shareholders, boards, and managers . . . should be imposed without shifting the fundamental balance of rights and obligations between shareholders and boards in ways that might alter the long-term viability of the U.S. corporation as the preferred vehicle for investment.”); cf. Julian Velasco, *Taking Shareholder Rights Seriously*, 41 UC DAVIS L. REV. 605, 607 (2007) (arguing for strengthening of existing stockholder rights such as voting and selling).

²³⁴ The reaction following the court's decision in *Smith v. Van Gorkom* is a good illustration of this. See, e.g., THERESE H. MAYNARD, *MERGERS & ACQUISITIONS: CASES, MATERIALS, & PROBLEMS* 486 (2d ed. 2009) (describing the history of Section 102(b)(7) and its adoption in response to *Van Gorkom*); Daniel R. Fischel, *The Business Judgment Rule and the Trans Union Case*, 40 BUS. LAW. 1437, 1455 (1985) (criticizing the court's emphasis on board process and referring to the case as “one of the worst decisions in the history of corporate law”).

protecting shareholders from board failures to provide effective oversight.”²³⁵ The reform discussed in this section focuses on empowering stockholders to influence corporate behavior by enforcing officer compliance with fiduciary duties.

There have been several proposals for strengthening the stockholder role in the corporation. Professor Bebchuk, for example, advises that the way to remedy this problem is by further empowering stockholder management, such as providing stockholders with the ability to propose amendments to the certificate of incorporation.²³⁶ As an alternative, Professor Ribstein has suggested that:

An alternative way to ensure more accountability to owner interests would be to give owners the power to cash out of the firm. Such a right might be given not only in response to major transactions, as under current law, but at will. This would give owners significantly more than they would get from merely being able to sell their interests on the market, since the price would be determined by the value of the underlying assets — that is, without the discount from mismanagement.²³⁷

Further, proposed and enacted state and federal legislation following Enron and the financial crisis evidence a shift toward affording stockholders a greater voice in corporate governance.²³⁸ These changes (both actual and proposed) provide stockholders with additional governance power in the form of proxy access for director nominees and advisory votes on executive compensation.²³⁹ In considering these and other proposals for an expansion of stockholder rights, it is important to keep in mind that they do not impact stockholders’ direct

²³⁵ ABA Report, *supra* note 10, at 121.

²³⁶ See Bebchuk, *The Case*, *supra* note 196, at 835, 867. Other proposals include requiring majority stockholder support for directors and stockholder approval of executive compensation. See Brian R. Cheffins & Randall S. Thomas, *Should Shareholders Have a Greater Say Over Executive Pay?: Learning from the US Experience*, 1 J. CORP. L. STUD. 277, 284-86 (2001) (discussing whether shareholders should have a say on executive pay); see also Marcel Kahan & Edward Rock, *The Hanging Chads of Corporate Voting*, 96 GEO. L.J. 1227, 1230 (2008) (discussing majority voting).

²³⁷ Ribstein, *supra* note 17, at 200-01.

²³⁸ See, e.g., 17 C.F.R. 240.14a-11 (2010) (providing rules for proxy access), *vacated*, Bus. Roundtable v. SEC, 647 F.3d 1144 (2011); DEL. CODE ANN. tit. 8, §§ 112, 113 (2014) (outlining proxy access and proxy reimbursement); see also O’KELLEY & THOMPSON, *supra* note 18, at 223 (observing that “there [has been] a perceptible shift in both federal and state law with regard to the substantive governance rights and power of shareholders”).

²³⁹ See *supra* notes 16 and 238.

enforcement of officer fiduciary duties.²⁴⁰ At best, prior proposals for strengthening the stockholders' role will have an indirect impact.

The most promising reform that would directly impact stockholder enforcement of officer fiduciary duties involves focusing on the availability and use of derivative litigation. The derivative lawsuit has its shortcomings and thus many critics.²⁴¹ Some of the cited problems associated with derivative litigation include: abuse by the defendants' and plaintiffs' bar, imposition of high litigation costs on the corporation, limited actual impact on promoting desirable behavior, and agency costs.²⁴² Nonetheless, the derivative lawsuit plays an important role in corporate governance and the balance of power between the board of directors, officers and stockholders.

Derivative litigation has been described as vital to a successful system of internal corporate governance and management accountability.²⁴³ Indeed, it is the most powerful tool available to stockholders in checking management power, whether it is at the board or officer level.²⁴⁴ Derivative lawsuits give meaning to the "abstract concepts of

²⁴⁰ Other considerations include costs that would come with them such as: (i) the increased decision-making costs that will result from a larger number of individuals being involved and (ii) the collective action problem remaining so really only large stockholders or groups of stockholders like the institutional investors would gain any meaningful control and their interests may differ from that of the corporation and its stockholders generally. See Ribstein, *supra* note 17, at 201 ("Reducing delegation by empowering shareholders may raise decision-making costs for some firms more than it lowers agency costs.").

²⁴¹ See, e.g., Fischel & Bradley, *supra* note 121, at 271-74 (discussing the criticisms of derivative litigation); Roberta Romano, *The Shareholder Suit: Litigation Without Foundation?*, 7 J.L. ECON. & ORG. 55, 84 (1991) [hereinafter *The Shareholder Suit*] (describing how stockholder litigation is a "weak, if not ineffective instrument of corporate governance"); see also Thomas P. Kinney, *Stockholder Derivative Suits: Demand and Futility Where the Board Fails to Stop Wrongdoers*, 78 MARQ. L. REV. 172, 172 (1994) (stating that "one of the most compelling debates in modern corporate law concerns the extent to which shareholder derivative suits should be allowed to police the behavior of managers and directors").

²⁴² See, e.g., Fischel & Bradley, *supra* note 121 (discussing the costs associated with derivative litigation); Romano, *The Shareholder Suit*, *supra* note 241, at 84 (discussing the problems with derivative suits).

²⁴³ See Eugene Rostow, *To Whom and for What End is Corporate Management Responsible?*, in *THE CORPORATION IN MODERN SOCIETY* 46, 48 (Edward S. Mason ed., 1961) (describing derivative suits as "the most important procedure the law has yet developed to police the internal affairs of corporations"); Reinier Kraakman et al., *When Are Shareholder Suits in Shareholder Interests?*, 82 GEO. L.J. 1733, 1733 (1994) ("Shareholder suits are the primary mechanism for enforcing the fiduciary duties of corporate managers."); Schwartz, *supra* note 18, at 324 (describing derivative litigation as the "heart of the accountability devices").

²⁴⁴ See *supra* notes 195-207 (discussing the shortcomings and relative

fiduciary obligations” and support the disciplinary effect of these duties.²⁴⁵ In addition, while hostile takeovers and the market for corporate control may be effective in instances of gross mismanagement, the derivative lawsuit is the most effective way to address single breaches of fiduciary duty.²⁴⁶

Further, a recent study by Professors Robert Thompson and Randall Thomas regarding public and private derivative lawsuits in Delaware over a two-year period resulted in little evidence that derivative suits are “strike suits” seeking quick settlements.²⁴⁷ In their work, Thompson and Thomas conclude that derivative litigation serves an important function beyond merely the outcome of a case.²⁴⁸ In the private company setting, they further conclude that derivative litigation performs an important role in policing management conduct.²⁴⁹ In the public company setting, Thompson and Thomas find significant benefits to derivative suits and, as compared to other forms of representative litigation, low agency costs.²⁵⁰ Despite these benefits, they hypothesize that in the public company context, derivative litigation is “strangled by procedural hurdles such as the demand requirement and other constraints . . . including special litigation committees.”²⁵¹

In light of the importance of the derivative lawsuit as an enforcement mechanism, revising the procedural requirements surrounding this tool to incentivize stockholders (or at a minimum, lessen the disincentives) to monitor and enforce officer fiduciary duties is needed. This could be accomplished, at least in part, with two changes. First, the demand requirement could be modified to excuse demand in limited

ineffectiveness of stockholders’ other management powers). As has been pointed out by proponents of derivative litigation, “the shareholder derivative suit [is] an important tool to encourage and enforce complying behavior.” Nees, *supra* note 40, at 214; see Schwartz, *supra* note 18, at 327 (stating that the “primary purposes of liability rules are to ‘create incentives to engage in socially desirable conduct,’ and ‘deter improper conduct” (quoting Fischel & Bradley, *supra* note 121, at 261)); *supra* note 243.

²⁴⁵ Kenneth B. Davis, Jr., *The Forgotten Derivative Suit*, 61 VAND. L. REV. 387, 436-37 (2008) (“Derivative litigation performs the task of translating the abstract concepts of fiduciary obligations, good faith, and fairness into the specific limits on the insiders’ ability to favor themselves.”).

²⁴⁶ See James D. Cox, *Compensation, Deterrence, and the Market as Boundaries for Derivative Suit Procedures*, 52 GEO. WASH. L. REV. 745, 752-53 (1984).

²⁴⁷ See Robert B. Thompson & Randall S. Thomas, *The Public and Private Faces of Derivative Lawsuits*, 57 VAND. L. REV. 1747, 1749-50 (2004).

²⁴⁸ *Id.* at 1749.

²⁴⁹ See *id.* at 1749, 1784-85.

²⁵⁰ *Id.* at 1792.

²⁵¹ *Id.*

circumstances. Second, revisions could be made to limit the role of the special litigation committee in the derivative process.

1. The Demand Excused Requirement

With respect to the first change to derivative procedural hurdles — modifying demand excusal — Thompson and Thomas have proposed excusing the demand requirement for stockholders that hold a one percent interest in the corporation.²⁵² The one percent threshold, they conclude, provides demand excusal to those stockholders who have a substantial financial interest in the corporation and are less likely to inflict injury through use of the derivative lawsuit.²⁵³ As an alternative, Thompson and Thomas note the possibility of allowing long-term holders of a corporation's stock to file a derivative lawsuit without first having to satisfy the demand requirement.²⁵⁴

While the proposals by Thompson and Thomas would, to some extent, alleviate some of the constraints on the use of derivative litigation, a better proposal for modifying derivative demand requirements is actually a combination of the two.²⁵⁵ This would be accomplished through setting an initial percentage threshold for excusing demand and then having such percentage ratchet back as the length of ownership increases to certain set benchmarks. In determining what percentage ownership to set for demand excusal, there are several options. In their article, Thompson and Thomas propose a one percent threshold.²⁵⁶ In a slightly different context, the statutes recently adopted creating the Delaware public benefit corporation provide stockholders of those corporations who own, individually or collectively, “at least 2% of the corporation's outstanding shares or, in the case of a corporation with shares listed on a national securities exchange, the lesser of such percentage or shares of at least \$2,000,000 in market value, may maintain a derivative lawsuit” the ability to enforce the directors' duties to manage the business and affairs of the corporation.²⁵⁷ A third option would be to look to the ownership percentages in the 2010 proxy access rule — Rule 14a-11 — which required stockholders, individually or collectively, to own at least three percent of the voting power of the

²⁵² *See id.* at 1790-91.

²⁵³ *Id.* at 1790.

²⁵⁴ *Id.* at 1790 n.144.

²⁵⁵ In their article, Thompson and Thomas do mention in a footnote (but do not discuss) the possibility of combining their first two proposals. *See id.*

²⁵⁶ *See id.* at 1790.

²⁵⁷ DEL. CODE ANN. tit. 8, §§ 365(a), 367 (2014).

corporation's stock in order to use the rule.²⁵⁸ Based on the competing interests involved in providing relief from the derivative demand requirements — incentivizing enforcement and protection of stockholder interests versus protecting the corporation from frequent and potentially frivolous litigation — a significant ownership threshold such as the three percent used in Rule 14a-11 seems appropriate. Further, in determining the ownership duration that would result in a reduction of the initial three percent ownership threshold, a three year holding period seems to strike an appropriate balance in providing stockholders who have a significant, long-term interest in the corporation the ability to use the derivative suit.²⁵⁹ Finally, setting a minimum ownership threshold of one percent, regardless of holding duration, would provide corporations with some level of protection from nuisance suits and high litigation costs.

Tying demand excusal to account for both size and length of stock ownership provides a relief from onerous demand requirements for those holders with a significant financial or temporal interest in the corporate enterprise. If demand excusal was limited to only large holders of stock, then institutional investors and activist investors would primarily benefit from such reform.²⁶⁰ The problem with focusing on only large holders is that they may be “myopic, to the end of increasing the value of a speculative option.”²⁶¹

There are similar concerns if demand excusal was limited to a specific holding time. In that instance, only long-term stockholders can benefit from derivative demand reform. While these stockholders may have more of a vested interest in being involved in corporate governance

²⁵⁸ Rule 14a-11 can be found at Facilitating Shareholder Director Nominations, Securities Act Release No. 9136, Exchange Act Release No. 62,764, Investment Company Act Release No. 29,384, 75 Fed. Reg. 56,668 (Sept. 16, 2010) (to be codified at 17 C.F.R. pts. 200, 232, 240, 249). In the adopting release, comments to the rule regarding setting a higher or lower ownership threshold are discussed. *See id.* at 56,688-96. Rule 14a-11 was ultimately vacated by the U.S. Court of Appeals for the D.C. Circuit's decision in *Bus. Roundtable v. SEC*, 647 F.3d 1144, 1148-49 (2011).

²⁵⁹ The proposed three year holding period is based on the holding period ultimately adopted in connection with Rule 14a-11. *See id.* at 56,697-99.

²⁶⁰ Professors Gilson and Gordon have found that the distribution of shareholdings of U.S. public corporations has changed from households to largely institutional investors. *See Gilson & Gordon, supra* note 195, at 874-78.

²⁶¹ *Id.* at 917; *see* Leo E. Strine, Jr., *Toward a True Corporate Republic: A Traditionalist Response to Bebchuk's Solution for Improving Corporate America*, 119 HARV. L. REV. 1759, 1765 (2006) (“Those institutions most inclined to be activist investors are associated with state governments and labor unions, and often appear to be driven by concerns other than a desire to increase the economic performance of the companies in which they invest.”).

issues like officer compliance with fiduciary duties, they may be focused primarily on long-term business strategy and goals for the enterprise.²⁶² Tying demand excusal solely to the length of stockholding also alienates those short-term, but large stockholders, who have a substantial financial stake in the corporation's business, and relatedly officer fidelity to fiduciary obligations in running the business for all stockholders. Participation by these larger stockholders is important because they are likely to have the financial wherewithal and sophistication to acquire and understand firm-specific information and investigations, which is helpful in monitoring and enforcing of officer duties.²⁶³ Accordingly, because "most shareholders have . . . divergent interests,"²⁶⁴ it is necessary that a modification to the derivative demand requirement be inclusive of as many different types of stockholders as possible, which is accomplished by this mixed proposal. Moreover, this type of limited modification to the demand requirements strikes the proper balance between incentivizing derivative litigation and protecting stockholder interests on the one hand, and deterring nuisance suits and preserving directors' power to manage corporate affairs, on the other.²⁶⁵

2. The Role of Special Litigation Committees

A second proposed revision to derivative procedural hurdles is to limit or eliminate the role of the special litigation committee. In *Zapata Corp. v. Maldonado*, the Delaware Supreme Court held that a board of directors could appoint a special litigation committee to consider whether derivative claims should be prosecuted, settled, or dismissed.²⁶⁶ The purpose behind the special litigation committee

²⁶² It has also been asserted that the interests of long-term stockholders do not actually align with maximizing the economic value of a corporation. See Jesse M. Fried, *The Uneasy Case for Favoring Long-term Shareholders*, 124 YALE L.J. (forthcoming 2014) (manuscript at 1-9), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2227080.

²⁶³ See Gilson & Gordon, *supra* note 195, at 891-95 (discussing the costs, expertise, and incentives attendant to stockholder exercise of governance rights).

²⁶⁴ See ABA Report, *supra* note 10, at 144.

²⁶⁵ The purpose behind *Aronson* is to prevent nuisance suits and balance the stockholders' right to protect the corporation and stockholders' interests therein with usurpation of the directors' normal power to manage the corporation. See generally *Agostino v. Hicks*, 845 A.2d 1110, 1115-17 (Del. Ch. 2004) (describing how the procedural rules in derivative litigation attempt to balance directors' authority to manage the business and affairs of the corporation with stockholders acting as a check on that power).

²⁶⁶ See *Zapata Corp. v. Maldonado*, 430 A.2d 779, 785-89 (Del. 1981).

concept was to promote the board's power to manage corporate affairs, including litigation decisions and prevention of frivolous litigation and associated costs.²⁶⁷ Unfortunately, even the Delaware judiciary has noted that "while perhaps laudatory in legal concept, [*Zapata*] has the pragmatic effect of setting up a form of litigation within litigation."²⁶⁸ Moreover, scholars have found that, in practice, "special litigation committees have often been used to stop judicial inquiry into the facts surrounding conflict of interest transactions."²⁶⁹

In light of this state of affairs, one possible revision would be to provide for a stronger presumption in favor of continuing derivative lawsuits and a more searching judicial inquiry into special litigation committee conclusions. *Zapata*, itself, actually calls for this type of review, providing that it should be the corporation's burden to prove "independence, good faith and reasonable investigation, rather than presuming [them]," and that the court should exercise "careful scrutiny" akin to "interested director' transactions, where the directors, once the transaction is attacked, have the burden of establishing its 'intrinsic fairness.'"²⁷⁰ Nevertheless, this heightened review does not appear to take place. While establishing entire fairness has been found to be a heavy burden that is generally outcome determinative in favor of the challenging stockholder,²⁷¹ review under *Zapata* indicates an opposite result, with courts seemingly taking a passive approach and deferring to the directors' decision-making.²⁷²

²⁶⁷ See *Biondi v. Scrushy*, 820 A.2d 1148, 1156 (Del. Ch. 2003) ("One of the obvious purposes for forming a special litigation committee is to promote confidence in the integrity of corporate decision making by vesting the company's power to respond to accusations of serious misconduct by high officials in an impartial group of independent directors.").

²⁶⁸ *Kaplan v. Wyatt*, 484 A.2d 501, 511 (Del. Ch. 1984).

²⁶⁹ Thompson & Thomas, *supra* note 247, at 1791; see also *Zapata*, 430 A.2d at 784; James D. Cox, *Searching for the Corporation's Voice in Derivative Suit Litigation: A Critique of Zapata and the ALI Project*, 1982 DUKE L.J. 959, 963 (1982) (reporting, as of 1982, that "although there have been more than a score of special litigation committees to date, in all but one the committee concluded that the suit in question was not in the corporation's best interests" (internal citations omitted)); Fairfax, *Spare the Rod*, *supra* note 39, at 409; Schwartz, *supra* note 18, at 339; Swanson, *Corporate Governance*, *supra* note 191, at 437; Swanson, *Juggling Shareholder Rights*, *supra* note 181, at 1357-58.

²⁷⁰ See *Zapata*, 430 A.2d at 788-89 & n.17 (internal citations omitted).

²⁷¹ See, e.g., *Reis v. Hazelett Strip-Casting Corp.*, 28 A.3d 442, 459 (Del. Ch. 2011) ("Entire fairness is Delaware's most onerous standard."); *AC Acquisitions Corp. v. Anderson, Clayton & Co.*, 519 A.2d 103, 111 (Del. Ch. 1986) ("Because the effect of the proper invocation of the business judgment rule is so powerful and the standard of entire fairness so exacting, the determination of the appropriate standard of judicial review frequently is determinative of the outcome of derivative litigation.").

²⁷² See *Zapata*, 430 A.2d at 784; Schwartz, *supra* note 18, at 339; Swanson, *Corporate*

Making the second prong of *Zapata* — whether the court, in its “own independent business judgment” in taking into consideration issues of law, public policy and corporation’s best interest, agrees with dismissing the action²⁷³ — a mandatory part of the court’s analysis will reinforce the heightened judicial review enunciated in *Zapata* and temper the current deference given to special litigation committees. Currently, the second prong of *Zapata* is a discretionary step in the court’s review of a committee’s dismissal recommendation,²⁷⁴ which has, in practice, been found to be rarely applied by courts.²⁷⁵ This part of the analysis is important however, because its function is to strike a balance between those derivative claims that have a legitimate basis and the determination by an independent committee of the board about what is in the best interests of the corporation.²⁷⁶ As the Delaware Supreme Court explained in its decision, “[t]he second step is intended to thwart instances where corporate actions meet the criteria of step one, but the result does not appear to satisfy its spirit, or where corporate actions would simply prematurely terminate a stockholder grievance deserving of further consideration in the corporation’s interest.”²⁷⁷

Mandating *Zapata*’s second prong will not eliminate the courts’ ability to consider the recommendation of a special litigation committee as a factor in whether to dismiss the suit, but would place a heavier burden on a committee to justify dismissal. Derivative suits that have withstood

Governance, *supra* note 191, at 437; Swanson, *Juggling Shareholder Rights*, *supra* note 181, at 1357-58; *see also* BALOTTI & FINKELSTEIN, *supra* note 47, § 13.17 (quoting Kaplan, 499 A.2d at 1192); Davis, *supra* note 245, at 389 (noting how courts are attempting to be more creative in their approach to preserving minority shareholder access to courts without displacing traditional restrictions on large cap derivative suits); Mary Siegel, *The Illusion of Enhanced Review of Board Actions*, 15 U. PA. J. BUS. L. 599, 600 (2013) (asserting that even when applying enhanced forms of review to board actions, courts defer to directors’ judgment in a manner similar to the standard business judgment rule).

²⁷³ *See Zapata*, 430 A.2d at 789.

²⁷⁴ “[T]he second step of the *Zapata* analysis is wholly within the discretion of the court’ and the Court may therefore decline to express its own independent business judgment.” BALOTTI & FINKELSTEIN, *supra* note 47, § 13.17 (quoting Kaplan, 499 A.2d at 1192).

²⁷⁵ While the second prong of *Zapata* allowing the court to substitute its own independent business judgment in deciding whether to dismiss the litigation has been cited as a move away from deferring to board decisions on derivative litigation, outcomes of motions to dismiss indicate that the courts still largely defer to the special litigation committee’s recommendation. *See* Schwartz, *supra* note 18, at 339; Swanson, *Corporate Governance*, *supra* note 191, at 437; Swanson, *Juggling Shareholder Rights*, *supra* note 181, at 1357-58; *see also* Davis, *supra* note 245, at 398 (noting that few courts have used the second prong of *Zapata*).

²⁷⁶ *See Zapata*, 430 A.2d at 789.

²⁷⁷ *Id.*

the challenging demand excused pleading requirements (and as a result are now subject to dismissal by a special litigation committee) are likely to have a sufficiently legitimate basis meriting continuation.²⁷⁸ By requiring the court to undertake its own independent review of the decision to dismiss a suit at this stage would discourage the deference courts have historically given to motions to dismiss at this stage and encourage the court to evaluate the relative strength of the litigation.²⁷⁹

Alternatively, a board's ability to make use of the special litigation committee could disappear when the suit is brought by stockholders holding a certain percentage of the corporation's stock and/or have held stock for a certain period of time. As discussed in the context of demand excusal, a mix of size and length of ownership would be the best modification. Additionally, the percentages and time periods discussed above could be used in determining when use of the special committee is eliminated. Similar to the demand excused proposal above, providing a limited elimination of special litigation committees to stockholders with either a substantial financial or temporal investment in a corporation incentivizes enforcement of officer duties, which in turn helps protect stockholder interests without undermining the purpose behind derivative procedural requirements.²⁸⁰ Further, as with the proposed reform to demand requirements, the proposed changes to

²⁷⁸ For further descriptions of the review of derivative claims under a Rule 23.1 motion to dismiss, see *Brehm v. Eisner*, 746 A.2d 244, 249 (Del. 2000); *Rales v. Blasband*, 634 A.2d 927, 934 (Del. 1993); *Grobow v. Perot*, 539 A.2d 180, 187 (Del. 1988), *overruled on other grounds by Brehm*, 746 A.2d at 253; *Aronson v. Lewis*, 473 A.2d 805, 814-16 (Del. 1984); *In re Nat'l Auto Credit, Inc.*, No. CIV.A.19028, 2003 WL 139768, at *12 n.69 (Del. Ch. Jan. 10, 2003); *Orman v. Cullman*, 794 A.2d 5, 27 (Del. Ch. 2002); BALOTTI & FINKELSTEIN, *supra* note 47, §§ 13.12, 13.14[B].

²⁷⁹ While the second prong of *Zapata* allowing the court to substitute its own independent business judgment in deciding whether to dismiss the litigation has been cited as a move away from deferring to board decisions on derivative litigation, outcomes of motions to dismiss indicate that the courts still largely defer to the special litigation committee's recommendation. See Schwartz, *supra* note 18, at 339; Swanson, *Corporate Governance*, *supra* note 191, at 437; Swanson, *Juggling Shareholder Rights*, *supra* note 181, at 1357-58; see also Davis, *supra* note 245, at 398. Further "the second step of the *Zapata* analysis is wholly within the discretion of the court' and the Court may therefore decline to express its own independent business judgment." BALOTTI & FINKELSTEIN, *supra* note 47, § 13.17 (quoting *Kaplan*, 499 A.2d at 1192).

²⁸⁰ See *Zapata*, 430 A.2d at 785-89; *Agostino v. Hicks*, 845 A.2d 1110, 1115-17 (Del. Ch. 2004); *Biondi v. Scrushy*, 820 A.2d 1148, 1156 (Del. Ch. 2003). Moreover, in the event that the proposed revisions to demand excusal be adopted, a corresponding elimination of the use of a special litigation committee where those same size or length of ownership thresholds were met would be important. If this were not the case, the demand excusal revisions would be undermined by the board's continuing ability to coopt these derivative claims and recommend their dismissal.

Zapata are intended to maintain a balance between the purposes behind derivative procedural requirements and provide meaningful enforcement power to stockholders through use of the derivative lawsuit.²⁸¹

CONCLUSION

The problematic nature of corporate officer power and the inadequacies in corporate governance, including constraining management and providing meaningful oversight and accountability is not lost on academia, the bench or the bar. This Article focuses on the role of state law fiduciary obligations in shaping officer conduct. Scholars agree that legal liability is an essential mechanism for ensuring officer fidelity to their fiduciary duties, yet the current state of corporate law does not promote this type of officer accountability. The development of the directors' duty of oversight and procedural requirements for stockholder derivative lawsuits, as well as other aspects of the fiduciary enforcement scheme, discourage active monitoring and enforcement. When coupled with an officer-dominated model of corporate management, meaningful enforcement of officers' fiduciary duties is scarce.

As a solution to the (un)enforcement of corporate officers' duties, this Article proposes a correction to the fiduciary enforcement scheme. As a general matter, reform to corporate law in this area should focus on the role of the board of directors and stockholders in enforcing officer fiduciary obligations. These two groups of corporate actors have the strongest incentives to participate in corporate governance and enforcement and are best positioned to monitor and enforce proper officer conduct. As between the board and stockholders, this Article focuses on strengthening the role of stockholders as an enforcer of officer fiduciary duties. Reevaluating and relaxing derivative lawsuit requirements for stockholders will improve enforcement incentives and

²⁸¹ Reform to the derivative litigation process in the special litigation committee context would not be radical, as modifications have already been recognized in jurisdictions outside of Delaware. See Davis, *supra* note 245, at 391 & n.15; see, e.g., *Miller v. Register & Tribune Syndicate, Inc.*, 336 N.W.2d 709, 718 (Iowa 1983) (excusing demand because of potential structural bias on the special litigation committee), *superseded by statute*, IOWA CODE § 490.744(2) (2007); *Alford v. Shaw*, 72 N.C. App. 537, 547 (1985) (holding that parties to a derivative suit cannot confer upon a special litigation committee the authority to control the litigation), *superseded by statute*, N.C. GEN. STAT. § 55-7-44(a) (2007) (holding that parties to a derivative suit cannot confer upon a special litigation committee the authority to control the litigation).

aid in ensuring that officers are being held accountable for their fiduciary obligations. Both excusing demand for certain stockholders and limiting the role of the special litigation committee in dismissing derivative lawsuits will help incentivize stockholders to use the primary enforcement tool available to them for enforcing officer fiduciary duties. Finally, as the role of officers and accountability for their fiduciary duties receives greater attention (whether through effective enforcement or otherwise), related questions such as the role of D&O insurance, indemnification, exculpation and the applicability of the business judgment rule to officers will become important issues necessitating further exploration and discussion.