Working Paper

Fiduciary Constraints: Correlating Obligation with Liability

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Ross School of Business Working Paper Series
Working Paper No. 1075
May 2007

Forthcoming in *Wake Forest Law Review*

FORTHCOMING WAKE FOREST LAW REVIEW 2007

Fiduciary Constraints: Correlating Obligation with Liability

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I. Introduction

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

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[1] Sarbanes Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified as amended in scattered sections of sections 11, 15, 18, 28, and 29 U.S.C.).
[2] *Id.* at § 302.
[3] *Id.*
[4] *Id*. at § 407.
[5] 1.7 C.F.R. §§ 228, 229, 249.

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

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

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

It is not difficult to think of federal statutes when considering the federal constraints on modern corporate executives of public companies.[6] The Sarbanes-Oxley Act.[7] The Securities Act of 1993.[8] The Securities and Exchange Act of 1934.[9] Unlike state corporate law, though, none of these statutes are grounded in fiduciary principles. Instead these statutes generally operate by imposing specific obligations on certain corporate actors.

An interesting exception to the standard framework of federal 'corporate' laws, however, is the Employee Retirement Income Security Act of 1974 (ERISA).[10] ERISA's fiduciary standards govern the conduct of every fiduciary of every employer-sponsored employee benefit plan. Its unique approach focuses on the acts of individual corporate actors to define the scope of fiduciary obligation. Some corporate officers, as well as directors, typically become benefit plan fiduciaries.[11] Accordingly, ERISA attempts to correlate blameworthy behavior with personal liability while maintaining the flexibility that is a hallmark of fiduciary standards. As a result, ERISA is helpful in anticipating the issues that state corporate law will confront in its increasing focus on officer liability. Its approaches, and the continuing challenges it is experiencing in addressing those issues, also inform our discussion of the future complications expected in corporate law.

Our goal is to identify the issues expected to arise as a result of the growing state law emphasis on individual liability and to contribute to the future debate on how best to

[6] *See generally, e.g.,* Robert B. Thompson & Hillary A. Sale, *Securities Fraud as Corporate Governance: Reflections upon Federalism*, 56 VAND. L. REV. 859, 859 (2003) ("federal law increasingly regulates the duties of officers.")
[7] Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified as amended in scattered sections of 11, 15, 18, 28, and 29 U.S.C.).
[8] 15 U.S.C. 77a-77aa (2000).
[9] 15 U.S.C. 78a-78mm (2000).
[10] Employee Retirement Income Security Act (ERISA), of 1974 §§ 1-4402, 29 U.S.C. §§ 1001-1461 (2000).
[11] *See infra* text accompanying notes 12-16 for discussion of fiduciary status.

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

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

We also find that ERISA continues to struggle in its efforts to evaluate conflicts of interest and in how to adjust the review of fiduciary decisions to account for those conflicts. We anticipate that corporate law will face similar difficulties in identifying and adjusting standards of fiduciary review for corporate officer conflicts of interest.

II. ERISA's Correlation of Behavior and Liability

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

A. Fiduciary Duties of Officers and Directors

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

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

In its definition of who is a fiduciary, ERISA is democratic in its treatment of officers and directors. The statute does not distinguish between directors, officers, or other individuals in terms of whether they are fiduciaries or in the scope of their liability.[12] Nor have the courts developed any jurisprudence treating officers differently from directors. Instead, the cases typically simply refer to the potential fiduciary liability or status of "officers and directors."[13] Unlike corporate law, there is no paucity of ERISA litigation alleging fiduciary breach by corporate actors below the rank of director. One explanation for the difference may be that, in contrast to corporate law, ERISA does not establish any demand requirement for suits alleging fiduciary breach.[14]

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[12] *See* H.R. Rep. No. 1280, 93d Cong., 2d Sess., *reprinted in* 1974 U.S. Code Cong. & Admin. News 5038, 5103 ("Under this definition, fiduciaries include officers and directors of a plan, members of a plan's investment committee and persons who select these individuals.")

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

[14] *See infra* text accompanying note 120 regarding the corporate law demand requirement.

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

1. The Role of Actions Compared to Designation

Under ERISA a person becomes a fiduciary – regardless of title or formal appointment - to the extent she exercises discretion over plan management or assets, she has discretionary authority over plan administration, or provides investment advice regarding plan assets in return for a fee.[17] This focus on actions has come to be known as a functional way of defining fiduciary status[18] and means that, unlike traditional trusts, benefit plans typically have far more than one or two trustees. The scope of each

[15] Gross v. Hale-Halsell Co., No. 04-CV-0098-CVE-FHM, 2006 U.S. Dist. LEXIS 66304, *19 (N.D. Okla. Sept. 15, 2006) ("Even under the broad definition of "fiduciary" …, an individual cannot be liable as an ERISA fiduciary solely by virtue of his position as a corporate officer or manager.").

[16] In addition there is the possibility of liability for co-fiduciaries and even liability for nonfiduciaries who aid or participate in a fiduciary breach. ERISA makes specific provision for co-fiduciary liability. ERISA § 405, 29 U.S.C. § 1105 (2000). It is less clear whether a nonfiduciary violates ERISA by participating in a fiduciary breach. *Compare* Mertens v. Hewitt Associates, 508 U.S. 248, 253-54 (1993) (Supreme Court in dicta stating: "And while ERISA contains various provisions that can be read as imposing obligations upon nonfiduciaries, including actuaries, no provision explicitly requires them to avoid participation (knowing or unknowing) in a fiduciary's breach of fiduciary duty. It is unlikely, moreover, that this was an oversight, since ERISA does explicitly impose 'knowing participation' liability on cofiduciaries.") *with* John Hancock Mut. Life Ins. Co. v. Harris Trust & Sav. Bank, 510 U.S. 86 (U.S. 1993) (subjecting Hancock to fiduciary obligation due to a contract).

[17] ERISA § 3(21)(A), 29 U.S.C. § 1002(21)(A) (2000).

[18] Beddall v. State St. Bank & Trust Co., 137 F.3d 12, 18 (10th Cir. 1998) ("The key determinant of whether a person qualifies as a *functional fiduciary* is whether that person exercises discretionary authority in respect to, or meaningful control over, an ERISA plan, its administration, or its assets (such as by rendering investment advice).") (emphasis added).

functional fiduciary's duties, however, is cabined by the principle that the officers and executives only act as plan fiduciaries when they are fulfilling plan fiduciary functions.

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

2. The Role of Role

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

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[19] In re Electronic Data Systems Corp. ERISA Litig., 305 F. Supp. 2d 658, 668 (E.D. Tex. 2004).
[20] *Id.* at 666.
[21] *Id.*
[22] ERISA § 402(a), 29 U.S.C. § 1102(a) (2000).

Plans may designate individuals or entities, such as the corporation or a plan committee, as the named fiduciary.[23] If a plan fails to name a plan fiduciary, then the company that sponsors the plan is treated as the named fiduciary.[24] The default is consistent with practice because plans frequently designate the company as the named fiduciary.[25]

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

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

The determination of fiduciary status for officers and executives becomes interesting when a benefit plan document designates the company or some other entity, such as a plan investment committee, as the named fiduciary. Corporate law principles establish that directors are responsible for oversight and management of the company through the appointment of corporate officers.[26] So, arguably, using the derivative approach, when the company is the named fiduciary then all directors necessarily become plan fiduciaries regardless of their actions and involvement with the plan because it is the

[23] EMPLOYEE BENEFITS LAW, *supra* note 13, at 652.
[24] ERISA § 3(16)(A)(ii), 29 U.S.C. § 1002(16)(A)(ii) (2000).
[25] Debra A. Davis, *Do-it-Yourself Retirement: Allowing Employees to Direct the Investment of Their Retirement Savings*, 8 U. PA. J. LAB. & EMP. L. 353, 376 (2006).
[26] HARRY G. HENN & JOHN R. ALEXANDER, LAWS OF CORPORATIONS § 207 (3d edition 1983).

directors who are ultimately charged with oversight and management of the company. Yet, holding directors responsible for all acts taken on behalf of a benefit plan would be inconsistent with ERISA's attempt to correlate fiduciary responsibility reasonably closely with fiduciary actions. Accordingly, in many situations directors are responsible for meeting their duty of care in the selection and oversight of lower level actors who, in turn, have fiduciary responsibility for their own acts.[27]

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

The Third Circuit has accepted the entity approach explaining:

> When a corporation is the "person" who performs the fiduciary functions . . . the officer who controls the corporate action is not also the

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

person who performs the fiduciary function. Because a corporation always exercises discretionary authority, control, or responsibility through its employees, [the statute] must be read to impute to the corporation some decisions by its employees. Otherwise, the fictional "person" of a corporation could never be a fiduciary because a corporation could never meet the statute's requirement of having discretion. We cannot read [the statute] in a way that abrogates a use of corporate structure clearly permitted by ERISA. [28]

Under the Third Circuit's rationale, officers and executives only become fiduciaries if they explicitly accept individual discretionary roles over plan management, assets, or administration.[29] For example, when a corporation is the named fiduciary it could formally delegate some portion of its fiduciary obligations to an officer or executive who accepts the delegation. That delegation would give rise to individual fiduciary status.[30] But, in the absence of a delegation, actions taken by officers and executives on behalf of the named fiduciary would not result in the individuals assuming any fiduciary obligations.

Other courts to have examined this issue have disagreed with the Third Circuit and follow the derivative approach. For example,[31] the Ninth Circuit reasoned that ERISA separately defines "fiduciary" and "named fiduciary" and does not contain an

[28] Confer v. Custom Eng'g Co., 952 F.2d 34, 37 (3d Cir. 1991).
[29] *See id.* The court actually refers only to discretion over plan administration as giving rise to fiduciary status. That language is understandable given the context of the case, but, given the relevant statutory language on functional fiduciary status, the court's reasoning would seem to extend to discretionary functions that relate to plan management or assets. It also would seem to apply to investment advice provided for a fee though that is rarely within the scope of duties of a corporate director or officer.
[30] *Id.*
[31] Kayes v. Pacific Lumber Co., 51 F.3d 1449, 1461 (9th Cir. 1994); *see also* Bannister v. Ullman, 287 F.3d 394, 403-06 (5th Cir. 2002) (determining that corporate officers were liable as fiduciaries).

exemption from fiduciary status for functional actors who perform duties as agents of a named fiduciary.[32] Further, the statute forbids relieving any fiduciary from liability except through insurance.[33] The Ninth Circuit viewed a benefit plan's provision, which stated that directors and officers did not act "as individual fiduciaries," as a prohibited attempt to relieve fiduciaries from liability.[34] Finally, the court buttressed its decision with Department of Labor regulations recognizing that fiduciary status may be based on functional activities.[35] The Ninth Circuit later extended its rationale to a situation where a benefit plan designated a committee instead of the company as the named fiduciary.[36] According to the court, "where, as here, a committee or entity is named as the plan fiduciary, the corporate officers or trustees who carry out the fiduciary functions are themselves fiduciaries and cannot be shielded from liability by the company."[37]

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

The resulting break in the link between responsibility for decision making and liability has an even more perverse implication when corporate officers and executives

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32 *Kayes*, 51 F.3d at 1460.
33 ERISA § 410, 29 U.S.C. § 1110 (2000).
34 51 F.3d at 1460.
35 *Id.* at 1460-61.
36 Stewart v. Thorpe Holding Co. Profit Sharing Plan, 207 F.3d 1143, 1156-57 (9th Cir. 2000).
37 *Id.* at 1156.

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

B. Linking Fiduciary Wrongdoing and Liability

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

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

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

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

The obligations of ERISA fiduciaries were originally derived from trust law. Although ERISA applies to the full spectrum of employer-sponsored benefit plans, Congress' focus on the regulation of pension plans is reflected even in ERISA's title –

the Employee *Retirement* Income Security Act.[38] It is hardly surprising then, given the use of trusts as pension vehicles prior to ERISA, that the regulation requires almost all plan assets to be held in trust.[39] Patterning ERISA's fiduciary standards after those established under trust law seems to have followed naturally from the traditional use and regulation of pension trusts.

Fiduciary status is relevant primarily to the extent that the status imposes constraints on the fiduciary. In addition to paralleling corporate law in its derivation of fiduciary standards from trust law, two of the duties that ERISA establishes parallel the duties of loyalty and care found in corporate law. ERISA's version of the duty of loyalty requires fiduciaries to act "for the exclusive purpose of: (i) providing benefits to participants and their beneficiaries; and (ii) defraying reasonable expenses of administering the plan."[40] In order to comply with the duty of care, an ERISA fiduciary must act in accordance "with the skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims."[41] In addition, ERISA requires fiduciaries to diversify the investments of some benefit plans and to act in accordance with plan documents to the extent the documents comply with ERISA.[42]

Although Congress patterned ERISA's fiduciary provisions on traditional trust law, it made clear that the standards should be construed "with modifications appropriate

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[38] Employee Retirement Income Security Act, of 1974 §§ 1-4402, 29 U.S.C. §§ 1001-1461 (2000).
[39] ERISA § 403(a); 29 U.S.C. § 1103(a) (2000).
[40] ERISA § 404(a)(1)(A), 29 U.S.C. § 1104(a)(1)(A) (2000). For a critique of this provision, see Daniel Fischel and John H. Langbein, *ERISA's Fundamental Contradiction: The Exclusive Benefit Rule*, 55 U. CHI. L. REV. 1105 (1988).
[41] ERISA § 404(a)(1)(B), 29 U.S.C. § 1104(a)(1)(B) (2000).
[42] ERISA § 404(a)(1)(C) & (D), 29 U.S.C. § 1104(a)(1)(C) & (D) (2000).

for employee benefit plans."[43] Specific ERISA deviations, such as the determination of fiduciary status,[44] tailor fiduciary obligation to the complexities of employee benefit plans. This is in contrast to corporate fiduciary law, which has relied primarily on a common law approach that hews more closely in traditional trust and agency law.

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

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

1. Considerations of Expertise

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

Commentators[45] and courts[46] are divided on whether ERISA's prudence standard is that of a prudent person or a prudent expert. The ambiguity begins in the statutory

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[43] Donovan v. Cunningham, 716 F.2d 1455, 1464 (5th Cir. 1983).
[44] *See supra* text accompanying notes 12-16.
[45] *Compare* Bernard Black, et al., *Outside Director Liability*, 58 STAN. L. REV. 1055, 1137 (2006) (stating that the ERISA standard is "often called a 'prudent expert' standard"); Mark J. Roe, *The Modern Corporation and Private Pensions*, 41 UCLA L. REV. 75, 102 (1993) (referring to "ERISA's prudent expert rule"), *with* EMPLOYEE BENEFITS LAW, *supra* note 13, at 666 ("Prudence is measured according to the objective 'prudent man" standard…'); see *also* David Hess, *Protecting and Politicizing Public Pension*

language. The reference to a "prudent man" requirement arguably sets the standard as that of a prudent person. Next, though, the language refers to the prudent man as "acting in a like capacity and familiar with benefit plans….,"[47] which some interpret to establish a prudent expert standard.[48]

The controversy in the case law is traceable to *Donovan v. Cunningham,*[49] a case dealing with alleged fiduciary breach in the context of the pricing of securities in an Employee Stock Ownership Plan (ESOP). The Fifth Circuit recognized that commentators had suggested that ERISA's language calls for a prudent expert standard. The court, however, stated that "a review of the relevant history of [the provision] does not support this view."[50] At the same time, the Fifth Circuit noted that the duty of care standard is flexible and stated both that "[t]he level of knowledge required of a fiduciary will vary with the nature of the plan"[51] and that "the adequacy of a fiduciary's investigation is to be evaluated in light of the 'character and aims' of the particular type of plan he serves."[52]

One court, like *Cunningham,* explicitly rejected the use of a "prudent expert" standard but at the same time established some flexibility in the standard. In *Harley v.*

Fund Assets: Empirical Evidence on the Effects of Governance Structures and Practices, 39 U.C. DAVIS L. REV. 187, 219 (2005) (suggesting that the appropriate focus is on "ensur[ing] that a board of trustees has the expertise to perform its duties").

[46] *Compare* In re: Bicoastal Corp., No. 89-8191-8P1, 1995 Bankr. LEXIS 1928 (M.D. Fla. Dec. 19, 1995) (The statutory section "explicitly holds fiduciaries to the standard of a prudent expert, rather than that of a prudent layman."); Howard v. Shay, No. CV 91-146 DT, 1993 U.S. Dist. LEXIS 20153, at *37 (C.D. Cal. Sept. 15, 1993) ("The standard is generally understood as that of a prudent expert."), *with* Donovan v. Cunningham, 716 F.2d 1455, 1467, n.26 (5th Cir. 1983) (deciding that a review of the provision's history does not support the prudent expert standard); Thompson v. Avondale Indus., No. 99-3439, 2003 U.S. Dist. LEXIS 2318, at *45 (E.D. La. Feb. 14, 2003) ("The reference in ERISA . . . to a prudent man 'familiar with such matters' does not create a 'prudent expert.'").

[47] ERISA § 404(a)(1)(B), 29 U.S.C. § 1104(a)(1)(B) (2000).

[48] *See* Black, et al., *supra* note 45, at 1137; Roe, *supra* note 45, at 102.

[49] 716 F.2d 1455, 1458 (5th Cir. 1983).

[50] *Id.* at 1467, n.26.

[51] *Id.*

[52] *Id.* at 1467.

Minnesota Mining and Mfg.,[53] the district court addressed claims that 3M breached its fiduciary duty by permitting company employees to invest defined benefit plan assets in a risky hedge fund. Ultimately, those investments allegedly depleted defined benefit plan assets by $80 million.[54] According to the court, "ERISA does not impose a rule that fiduciaries be 'experts' on all types of investments they make."[55]

In spite of rejecting the expert standard of care, the *Harley* court's analysis set a flexible and relatively high standard of care. First, it opined that fiduciaries without the expertise to properly evaluate investment options must hire independent advisors.[56] The company had argued that it hired the hedge fund, which had recommended the investments, in order to obtain investment expertise and that it should not be required to hire another expert to oversee the expertise of the hedge fund.[57] According to the court, however, 3M had a continuing obligation to oversee and monitor the hedge fund. Since 3M did not have the internal expertise to perform that oversight, in order to fulfill its duty of care it should have sought outside assistance.[58] The court rejected 3M's summary judgment request on the basis that the company's oversight could reasonably be found to be below the standard of care.

Two courts have explicitly adopted a prudent expert standard under ERISA. *Howard v. Shay*[59] presented as an ESOP's sale of securities of a privately-held company to a trust established in favor of the son of the company's primary owner. Plaintiffs, all employees of the company and participants in the ESOP, alleged that the securities were

[53] 42 F. Supp. 2d 898, 900-04 (D. Minn. 1999), *aff'd on other grounds*, 284 F.3d 901 (8th Cir. 2002) (finding no cognizable damage to the plan).
[54] 42 F. Supp. 2d at 904.
[55] *Id.* at 907.
[56] *Id.*
[57] *Id.*
[58] *Id.* at 908.
[59] No. CV 91-146 DT, 1993 U.S. Dist. LEXIS 20153, at *2-3 (C.D. Cal. Sept. 15, 1993).

sold for less than fair market value.[60] They brought suit for breach of ERISA's fiduciary obligations against company officers as well as directors.[61] The court did not distinguish in any way between the fiduciary obligations of the directors and those of the officers. It did decide though that, while the duty of care is primarily procedural, the applicable standard is "that of a prudent expert."[62] The court went on to state that the duty of care "may also require a fiduciary to obtain expert advice . . ."[63] The ESOP committee had relied on an independent valuation and fairness opinion by Arthur Young & Company to set the price of the securities.[64]

In the most recent decision to address the role of expertise in an ERISA plan, the district court in *Thompson v. Avondale Industries, Inc.*,[65] cited *Cunningham* in deciding that: "The reference in ERISA . . . to a prudent man 'familiar with such matters' does not create a 'prudent expert' under ERISA, and prudent fiduciaries are entitled to rely on the advice they obtain from independent experts." As in *Howard*, the plaintiffs in *Thompson* were employee participants in an ESOP.[66] The employees alleged that plan fiduciaries breached their obligations by causing the ESOP to reduce its holdings of employer stock in order to reduce the power of the employees and the union.[67] The fiduciary defendants consisted of members of the company's ESOP committee as well as executive officers who also served as company directors. The court found that the ESOP committee

[60] *Id.* at *2.
[61] *Id.*
[62] *Id.* at *37.
[63] *Id.*
[64] *Id.* at *11-19; *see also In re:* Bicoastal Corp., 191 B.R. 238, 243 (M.D. Fla. 1995) ("[ERISA's fiduciary provision] explicitly holds fiduciaries to the standard of a prudent expert, rather than that of a prudent layman. In situations where Pension Plan fiduciaries are making loans, the fiduciary is held to the standard of professional bankers and bank investment advisers.").
[65] No. 99-3439, 2003 U.S. Dist. LEXIS 2318, at *45 (E.D. La. Feb. 14, 2003).
[66] *Id.* at *3.
[67] *Id.* at *6-7.

members met their duty of care in selling company securities held by the ESOP.[68] The management defendants similarly met their duty of care by choosing committee members who were long-time company employees from varied areas of the workforce.[69]

In sum, the courts and commentators are divided on whether ERISA's duty of care establishes a prudent expert standard. At minimum, though, the standard typically being applied is a flexible standard that takes into account the nature of the benefit plan at issue and, if the claim deals with investment of plan assets, the level of sophistication of the investments. There is no evidence that courts have taken into account the expertise of plan fiduciaries and held fiduciaries with greater expertise to a higher level of care as did the Delaware chancery court did in its decision in *ECM*.[70]

2. Use of Deferential Standards Favoring Corporate Officers

Corporate law commentators have taken opposing positions on whether officers should be entitled to the protection of the business judgment rule.[71] In contrast, as with the determination of fiduciary status and application of fiduciary standards, the ERISA jurisprudence does not draw any distinction in the application of ERISA's deferential standards based on whether the individual fiduciaries are directors, officers, or other actors. As discussed in the next subsection, though, there are substantial questions about and criticism of the scope of ERISA's deferential standards based primarily on considerations of conflicts of interest. This subsection considers the derivation of two deferential standards used to review fiduciary decisions.

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[68] *Id.* at *37-38.
[69] *Id.* at *66-69.
[70] No. 16415, 2004 Del. Ch. LEXIS 70 (Del. Ch. June 4, 2004); *see infra* text accompanying notes 183-196 for a discussion of *ECM*.
[71] *See infra* text accompanying notes 156-76.

The business judgment rule itself has no application in the ERISA context. One district court in an ERISA case explained its decision in favor of the defendants by stating: "Utilizing the 'business judgment' rule, this Court cannot find that the PAE ESOP committee breached any fiduciary duty in relying on the Arthur Young & Company [valuation]."[72] On appeal, the Ninth Circuit reversed, finding that the business judgment rule has no relevance in evaluating whether an ERISA fiduciary has met the standards of care and loyalty.[73]

While rejecting the applicability of the business judgment rule, the ERISA jurisprudence has developed deferential reviews for specific decisions of ERISA fiduciaries. For example, the Third Circuit developed a presumption that ESOP fiduciaries who decide to invest ESOP assets in employee stock have met their duties of care.[74] Plaintiffs may overcome the presumption by showing the investment decision constituted an abuse of discretion.[75] The Third Circuit suggests that "circumstances not known to the settlor and not anticipated by him [that] would defeat or substantially impair the accomplishment of the purposes of the trust"[76] could be sufficient to rebut the presumption.

The Third Circuit derived the ESOP investment presumption and abuse of discretion standard from ERISA's statutory language, which favors the use of ESOPs, as well as the statue's basis in the law of trusts.[77] The court also looked back at the

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[72] Howard v. Shay, No. CV 91-146 DT, 1993 U.S. Dist. LEXIS 20153, at *40 (C.D. Cal. Sept. 15, 1993).
[73] 100 F.3d 1484, 1489 (9th Cir. 1996) ("The business judgment rule is a creature of corporate, not trust, law").
[74] Moench v. Robertson, 62 F.3d 553, 571 (3rd Cir. 1995).
[75] *Id.*
[76] *Id.* at 571 (quoting Restatement (Second) of Trusts 227 comment g (1959)).
[77] *Id.* at 568-69.

Supreme Court's foundational 1989 decision in *Firestone v. Bruch.*[78] Although explicitly limited to fiduciary determinations of benefit eligibility, the *Firestone* Court relied heavily on trust law to adopt an abuse of discretion standard of review when the benefit plan grants interpretative discretion to a plan fiduciary.[79]

Some courts have considered extending the presumption in favor of ESOP investments in employer stock to the 401(k) context.[80] Commentators, including us, have expressed wariness about broader application of the ESOP presumption because it is not supported by the statutory language governing the pension savings goals of 401(k) plans.[81] It appears to be accepted without question, though, that in whatever contexts the presumption applies, it applies to all fiduciaries charged with the relevant decision making, regardless of their status as directors, officers, or even outsiders of the employer that sponsors the plan. Similarly, in the context of determinations of benefit eligibility, the criticisms directed at the abuse of discretion standard typically are grounded in the conflicts of interest of fiduciaries relying on that standard. Otherwise, the fiduciary's position vis-à-vis the sponsoring employer and the benefit plan is irrelevant.

Perhaps the most widely applied deferential standard in ERISA is the standard that is used to evaluate decisions on benefit eligibility. In *Firestone Tire & Rubber Co. v. Bruch,*[82] the Supreme Court approved the use of a deferential standard to review benefit eligibility decisions when a benefit plan grants interpretative discretion to the appropriate

[78] 489 U.S. 101 (1989).
[79] *Id.* at 111.
[80] *See, e.g.*, WorldCom Litig., 263 F. Supp. 2d 745, 764-65 (S.D.N.Y. 2003) (citing *Moench*, 62 F.3d at 571*)*.
[81] *See, e.g.* Dana M. Muir & Cindy A. Schipani, *New Standards of Director Loyalty and Care In the Post-Enron Era: Are Some Shareholders More Equal Than Others?* 8 N.Y.U .J.LEGIS. & PUB. POL'Y 279, 334 (2005) ("The absence of a statutory requirement that 401(k) plan assets be invested primarily in employer stock and the potential for conflicts of interest may militate for a more stringent level of scrutiny of fiduciary compliance with ERISA's prudence standards in those cases.").
[82] 489 U.S. 101 (1989).

plan fiduciary. The Supreme Court distinguished between situations where the terms of a trust grant interpretative discretion to the plan trustee, in which case a deferential standard of review is appropriate,[83] and plans such as the termination plan at issue in *Firestone*, in which it called for eligibility decisions to be reviewed using a de novo standard.[84]

Looking only at this portion of the *Firestone* decision, it appears that plan sponsors may attain a deferential standard of review for benefit decisions by including plan language that reserves deference to the plan administrator. When a benefit plan contains such a grant of discretion, the standard of review applied is stated as either arbitrary and capricious or abuse of discretion.[85] *Firestone* is not quite that simple though. The Supreme Court recognized that fiduciary conflicts of interest should affect the standard of review, stating that: "[I]f a benefit plan gives discretion to an administrator or fiduciary who is operating under a conflict of interest, that conflict must be weighed as a 'facto[r] in determining whether there is an abuse of discretion.'"[86] The circuits have struggled since *Firestone* to articulate standards of review that properly account for the existence of conflicts.[87] The next subsection turns to the serious difficulties courts have confronted in dealing with conflicts of interest by ERISA fiduciaries.

3. The Impact of Conflicts of Interest

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[83] *Id.* at 111.
[84] *Id.* at 112.
[85] Mark D. DeBofsky, *What Process is Due in the Adjudication of ERISA Claims?*, 40 J. MARSHALL L. REV. [2] (forthcoming Spring 2007).
[86] *Id.* at 115 (quoting Restatement (Second) of Trusts § 187, comment d (1959).
[87] DeBofsky, *supra* note 85.

One of the most intractable problems ERISA has confronted has been how to adjust fiduciary standards, including the deferential review standards, for conflicts of interest. The problem is inherent in ERISA because the statute builds in a structural conflict of interest by explicitly allowing agents of plan sponsors to act as ERISA fiduciaries.[88] The departure from traditional trust law is rationalized by the argument that benefit plan sponsorship is voluntary and employers would be unduly discouraged from sponsoring plans if they were not permitted to designate their own agents as plan fiduciaries.[89] This very rationalization, however, implicitly recognizes that those employer agents may be tempted to act contrary to the interests of the employees who rely on the benefit plan.

The problem of conflicts of interest has challenged the courts, particularly in the context of deferential review standards. In establishing the ESOP investment presumption, the Third Circuit recognized the relationship between conflicts of interest and the duty of care. The fiduciaries of a company struggling with financial difficulties will often be subject to competing interests.[90] As a result, according to the court: "[T]he more uncertain the loyalties of the fiduciary, the less discretion it has to act."[91]

As discussed above, in *Firestone*, the Supreme Court recognized that fiduciary conflicts of interest should affect the standard of review and suggested weighing the conflict as a factor.[92] The lower courts' application of *Firestone's* abuse of discretion standard to review benefit determinations has garnered significant criticism from

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[88] ERISA § 408(c)(3), 29 U.S.C. § 1108(c)(3) (2000).
[89] *See* Fishel & Langbein, *supra* note 40, at 1126-27.
[90] Moench v. Robertson, 62 F.3d 553, 572 (3rd Cir. 1995).
[91] *Id.*
[92] 409 U.S.101, 115 (1989) (quoting Restatement (Second) of Trusts § 187, comt. d (1959).

commentators[93] particularly when the fiduciary is operating under a conflict of interest. Of particular interest for purposes of this article is the circuits' struggle to determine whether an insurer, operating as a fiduciary decision maker, acts under a sufficient conflict of interest to require application of other than the arbitrary and capricious standard of review, and if so what the standard should be. Most circuits at least indicate concern with conflicts in this context.[94] The Seventh Circuit, though, has rejected arguments that such conflicts should give rise to increased scrutiny of fiduciary decision making.[95]

III. Corporate Law

Corporate law is more settled than ERISA in establishing that corporate officers are fiduciaries. Yet, although corporate law jurisprudence significantly predates the enactment of ERISA,[96] corporate case law relating to the standards of fiduciary analysis for corporate officers seems rather undeveloped when compared to the ERISA case law. Courts considering these issues might find the ERISA courts' analyses, focusing on the obligations of fiduciaries, instructive.

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

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

[94] DeBofsky, *supra* note 85, at [9-10].

[95] *Id.* at 10.

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

court considered the background and experience of one of the outside directors on the board of Emerging Communications, Inc., in deciding that he breached his fiduciary duty to the minority shareholders.[97] The court distinguished this director's obligation, and therefore liability, from that of the other members of the board. Similarly, although there are relatively few cases in which directors have been found liable for due care violations, some of the early cases finding liability involved the special obligations of directors of financial institutions.[98] In these cases, the courts emphasized the role directors of financial institutions play in upholding the public trust.

Although not directly addressing a liability issue, it is also noteworthy that the Delaware Chancery Court recently found it necessary to consider the relationships of directors with each other to address the issue of their independence. These cases arose in the context of judicial determination of whether the directors serving on a special litigation committee met the threshold of independence – enabling them to exercise impartiality when determining whether the shareholder derivative litigation should proceed.[99] The Chancery Court examined the extent these relationships could potentially compromise their ability to render impartial decisions.

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

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[97] In re Emerging Commc'n., Inc. S'holder Litig., No. 16415, 2004 Del. Ch. LEXIS 70 (Del. Ch. June 4, 2004). *See infra* notes 183-96 and accompanying text for further discussion of this case.
[98] Cindy A. Schipani, *Should Bank Directors Fear FIRREA: The FDIC's Enforcement of the Financial Institutions Reform, Recovery and Enforcement Act*, 17 J. CORP. L. 739, 748-51 (1992). *See infra* notes 198-210 and accompanying text for discussion of this issue.
[99] *See supra* notes 212-23 and accompanying text for discussion of this issue.

We begin this Section with a discussion of the fiduciary duties of officers and directors in Part A. In Part B we consider the genesis of the corporate law fiduciary duty and the role of the law of trusts and agency to the extent they are relevant to our analysis. Part C explores the current debate in the corporate law arena regarding whether officers should be afforded the presumption that their decisions were made in good faith and in the best interest of the corporation – i.e., whether their decisions should be protected by the deferential business judgment rule. In Part D, we discuss three corporate law contexts, identified above, where courts have considered specific contexts relevant to the duties and obligations of directors. We conclude that it is likely that such a contextual approach may be applied by future courts attempting to correlate the obligations of officers with liability.

A. Fiduciary Duties of Officers and Directors

It is well settled that officers and directors are fiduciaries under Delaware law.[100] The two primary fiduciary obligations are the duty of loyalty and the duty to act with due care.[101] The duty of loyalty requires that corporate interests supersede personal interests, and when conflicts of interest occur, they must either be avoided or disclosed and approved by disinterested directors.[102] In addition to the duties of care and loyalty,

[100] Aaron D. Jones, *Corporate Officer Wrongdoing and the Fiduciary Duties of Corporate Officers Under Delaware Law*, at 2, http://law.bepress.com/cgi/viewcontent.cgi?article=7809&context=expresso ("State corporate law is clear that officers are fiduciaries, but that is about all that is clear regarding the state law obligations of corporate officers.")
[101] *Id.* at 7-9.
[102] For a more in-depth consideration of the duty of loyalty see Dana M. Muir & Cindy A. Schipani, *The Challenge of Company Stock Transactions for Directors' Duties of Loyalty*, 43 HARV. J. ON LEGIS., 437 (2006). A majority of jurisdictions have codified the duty of loyalty. *See* ALA. CODE § 10-2B-8.30 (2006); ALASKA STAT. § 10.06.450 (2007); ARIZ. REV. STAT. ANN. § 10-830 (2007); CAL. CORP. CODE § 309 (Deering 2007); CONN. GEN. STAT. ANN. § 33-756 (West 2007); FLA. STAT. ANN. § 607.0830 (LexisNexis 2007); GA. CODE ANN. § 14-2-830 (2006); HAW. REV. STAT. ANN. § 414-221 (LexisNexis 2006); IOWA

corporate actors are faced with a duty to act in good faith; though, the Delaware Supreme Court has recently opined that the duty to act in good faith is part of the duty of loyalty and that lacking good faith alone will not trigger liability.[103]

The duty of care requires corporate actors to perform their duties with the reasonable care of a prudent person acting under similar circumstances.[104] In addition, the duty of care, at least as it has been applied to the duty of directors, requires that directors be adequately informed.[105]

As will be discussed below, Delaware law further modifies the duty of care by applying the business judgment rule with the result that liability emerges only in the case of gross negligence.[106] This was the holding of the Delaware Supreme Court in *Smith v. Van Gorkom*[107] where directors were held to have been grossly negligent in the process employed in approving a merger. The *Van Gorkom* court found that the directors failed to obtain all reasonably available information regarding the true intrinsic value of the corporation before recommending that the shareholders accept the proposed tender offer.[108] This failure in process supported a finding of gross negligence.

CODE ANN. § 490.830 (2007); KY. REV. STAT. ANN. § 271B.8-300 (LexisNexis 2006); ME. REV. STAT. ANN. tit. 13-C, § 831 (2006); MD. CODE ANN., CORPS. & ASS'NS § 2-405.1 (West 2007); MASS. GEN. LAWS ANN. ch. 156B § 65 (West 2007); MICH. COMP. LAWS ANN. § 450.1541A (West 2007); MINN. STAT. ANN. § 302A.251 (West 2007); MISS. CODE ANN. § 79-4-8.42 (2006); MONT. CODE ANN. § 35-2-441 (2005); N.H. REV. STAT. ANN. § 293-A:8.30 (2006); N.M. STAT. ANN. § 53-4-18.1 (West 2007); N.C. GEN. STAT. § 55-8-30 (2006); N.D. CENT. CODE § 10-19.1-50 (2005); OHIO REV. CODE ANN. § 1701.59 (LexisNexis 2007); OR. REV. STAT. ANN. § 60.357 (West 2005); 15 PA. CONS. STAT. ANN. § 1712 (2006); S.C. CODE ANN. § 33-8-300 (2006); TENN. CODE ANN. § 48-18-301 (2006); VA. CODE ANN. § 13.1-690 (2006); WASH. REV. CODE ANN. § 23B.08.300 (West 2007); W.VA. CODE ANN. § 31D-8-830 (LexisNexis 2007); WYO. STAT. ANN. § 17-16-830 (2006).

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

104 *See* sources *infra* note 131 , and accompanying text. *See also* Carter G. Bishop, *A Good Faith Revival of Duty of Care Liability in Business Organization Law,* 41 TULSA L. REV. (forthcoming), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=930402.

105 *See* Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985).

106 *Id.* at 880.

107 *Id*. at 873.

108 Smith v. Van Gorkom, 488 A.2d at 874**.**

In addition, directors may be exculpated for grossly negligent conduct if such a provision is included in the company's articles of incorporation.[109] Approximately eighteen months after the decision in *Smith v. Van Gorkom*, the Delaware legislature promulgated Section 102(b)(7) of the Delaware Code to permit corporations to further limit or even eliminate monetary liability for due care violations of directors vis-à-vis the corporation and its shareholders.[110] Thus, even though the standard of care is one of

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[109] DEL. CODE ANN. tit. 8, § 102(b)(7) (2007).

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

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

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

gross negligence, there is no monetary liability attached to the violation in shareholder suits provided that there is no evidence of breach of the duty of loyalty, intentional misconduct or lack of good faith.[111] Perhaps even more noteworthy is that Section 102(b)(7) is not available to exculpate negligent conduct of officers.[112]

The Delaware Supreme Court recently had occasion to consider whether directors breached their duty of care in In Re *The Walt Disney Co. Derivative Litigation*.[113] One of the allegations made against the Disney directors was that they were not adequately informed of the value of the severance package that would be paid to President Michael Ovitz in the event of a no-fault termination of his employment contract.[114] Moreover, the plaintiffs further alleged that such failure to fully inform themselves regarding the potential payout of the no-fault termination provision of the contract evidenced lack of good faith. The allegation regarding lack of good faith was important in this case because even if the Disney directors violated the duty of care, the shareholders would not be entitled to recover monetary damages. The articles of incorporation of The Walt Disney Corporation include a Section 102(b)(7)-type provision exculpating the Disney directors for monetary liability to the corporation and the shareholders for fiduciary violations not involving breach of loyalty, lack of good faith or intentional misconduct.

The Chancery Court, however, found that the directors were adequately informed regarding the Ovitz employment contract its decision was affirmed by the Delaware

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1701.59(c) (LexisNexis 2007). Wisconsin automatically provides for exculpation, unless the corporation provides otherwise. WIS. STAT. ANN. § 180.0828 (West 2007). The following statutes permit exculpatory language in the corporate bylaws. HAW. REV. STAT. ANN. § 414-32(5) (LexisNexis 2006); UTAH CODE ANN. § 16-10a-841(1) (2006); VA. CODE ANN. § 13.1-692.1 (2006).

[111] DEL. CODE ANN. tit. 8, § 102(b)(7) (2007).

[112] *Id.*

[113] *In re* The Walt Disney Co. Derivative Litig., 2006 Del. LEXIS 307 (Del. 2006).

[114] *Id*. at 66.

Supreme Court.[115] It was important to the courts that the directors were apprised of the material facts. Although, as noted by the Chancery Court, the directors' practices were not best practices, they did not fall so short as to constitute gross negligence.[116]

While a number, albeit not a large number, of cases have been decided defining the scope of the director's corporate fiduciary duty, there are fewer cases in Delaware involving the scope of the officer's duty.[117] Moreover, in cases where the duty of the officer is discussed, it is most often mentioned only in dicta in cases involving the liability of directors.[118] That is, courts often do not distinguish between the duties of an officer versus a director and discuss the duties of officers and directors as if the two are inextricably linked. This approach originated in the days preceding the governance practice of appointing a majority of independent directors to the board. Thus, it may have been in true in the earlier cases that all the directors were officers – so that they were in fact inextricably linked.

More recently, some federal district courts, purportedly applying Delaware law, have found that the officer's duties are the same as the director's.[119] It may be true that the Delaware judiciary sees no reason to distinguish between the fiduciary duty of care of directors and officers. The law, however, has not yet been so clearly articulated by the Delaware courts.

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[115] *Id*.
[116] *Id*. at 72-74.
[117] Lawrence A. Hamermesh & A. Gilchrist Sparks III, *Corporate Officers and the Business Judgment Rule: A Reply to Professor Johnson*, 60 BUS. Law. 865, 867 (2005) [hereinafter Hamermesh & Sparks 2005]; Lyman P.Q. Johnson & David Millon, *Recalling Why Corporate Officers are Fiduciaries*,46 WM. & MARY L. REV. 1597, 1601 (2005).
[118] Johnson & Millon, *supra* note 117, at 1610-11.
[119] A. Gilchrist Sparks, III & Lawrence A. Hamermesh, *Common Law Duties of Non-Director Corporate Officers*, 48 BUS. LAW. 215, 230 (1992) [hereinafter Sparks & Hamermesch 1992], citing Stanziale v. Nachtomi, 2004 U.S. Dist. LEXIS 7375 (D. Del. 2004); Grassmueck v. Barnett, 2003 WL 22128263 (W.D. Wash. 2003); Washington Bancorp. v. Said, 812 F. Supp. 1256 (D.D.C. 1993).

A number of reasons have been advanced to explain the paucity of Delaware cases involving the duty of care of officers. Mr. Sparks and Professor Hamermesch explain that such claims may only brought by shareholders through the derivative suit mechanism, and that the demand requirements effectively bar such litigation.[120] In addition, Professor Johnson notes that although the board may bring suit against officers, the board has other means at its disposal to discipline corporate officers, without resorting to litigation.[121] These methods include enforcement of contractual provisions which may result in termination, compensation penalties, or other negative employment consequences.[122] Furthermore, the Delaware legislature has only somewhat recently conferred personal jurisdiction on the Delaware courts over officers.[123] Commentators have surmised that the lack of personal jurisdiction may account for the lack of cases against officers who were not also directors.[124] Yet, as noted by Professors Johnson and Millon, the causation issue may run in the other direction.[125] If no one believed officers "occup[ied] a fiduciary status distinct from that of directors,"[126] there would not have been a reason to confer jurisdiction over officers.[127]

B. Genesis of Corporate Fiduciary Duties

[120] Hamermesh & Sparks 2005, *supra* note 117, at n. 13.
[121] Lyman P.Q. Johnson, *Corporate Officers and the Business Judgment Rule,* 60 BUS. LAW. 439, 465-66 (2005); Johnson & Millon, *supra* note 117, at 1611-12.
[122] Johnson & Millon, *supra* note 117, at 1611.
[123] *Id.* at 1612. Del. Code Ann. Tit. 10, § 3114 (2007).
[124] *See* Johnson & Millon, *supra* note 117, at 1612, citing William B. Chandler III & Leo E. Strine, Jr., *The New Federalism of the American Corporate Governance System: Preliminary Reflections of Two Residents of One Small State*, 152 U. PA. L. REV. 953, 1003 (2003); Hillary A. Sale, *Delaware's Good Faith*, 89 CORNELL L. REV. 456, 462, n. 28 (2004).
[125] *See* Johnson & Millon, *supra* note 117, at 1613.
[126] *Id*.
[127] *Id.* Furthermore, they reason that now that the Chancery Court has jurisdiction over officers, "agency law provides the legal rationale for imposing fiduciary duties on corporation officers and can provide the theory supporting monetary claims by the corporation based on officer misconduct." *Id.*

The fiduciary duties of corporate law appear to have emanated from the duties inherent in trust and agency law. Elsewhere, we have reviewed the relevance of trust law to the genesis of corporate fiduciary duties, noting that although corporate directors and officers are technically not trustees of the corporation, the case law has analogized to the law of trusts in defining the scope of their fiduciary obligation.[128] For example, according to the Delaware Supreme Court, "[c]orporate officers and directors are not permitted to use their position of trust and confidence to further their private interests . . . . The rule that requires an undivided and unselfish loyalty to the corporation demands that there be no conflict between duty and self interest."[129]

According to the Restatement of Trusts, the duty of care of a trustee is the prudent investor standard, which requires that trustees exercise such care and skill as is reasonable in the circumstances, having particular regard to special knowledge or experience that the trustee has or claims to have.[130] State courts and legislatures have reframed this duty as applied to directors as requiring directors to exercise the duty to require the degree of care ordinarily prudent persons would exercise under similar circumstances.[131] Many states have codified the duty of care.[132]

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[128] Muir & Schipani, *supra* note 102, at 444. *See also* Henry Ridgely Horsey, *The Duty of Care Component of the Delaware Business Judgment Rule*, 19 DEL. J. CORP. L. 971, 973 (1994); Edward Rock & Michael Wachter, *Dangerous Liaisons: Corporate Law, Trust Law, and Interdoctrinal Legal Transplants*, 96 NW. U. L. REV. 651, 651 (2002); L.S. Sealy, *Fiduciary Relationships*, 1962 CAMBRIDGE L.J. 69, 70 (1962); Joseph T. Walsh, *The Fiduciary Foundation of Corporate Law*, 27 J. CORP. L. 333 (2002).
[129] Guth v. Loft, Inc., 5 A.2d 503, 510 (Del. 1939). This language was also quoted recently by the Delaware Chancery Court in the recent litigation involving the Walt Disney Corporation. *In re* Walt Disney Co. Derivative Litig., 2005 Del. Ch. LEXIS 113, *aff'd*, 2006 LEXIS 307 (Del. 2006).
[130] RESTATEMENT (SECOND) OF TRUSTS § 174 (1959).
[131] *See, e.g.*, Graham v. Allis-Chalmers Mfg.Co., 188 A.2d 125, 130 (Del. Ch. 1963). See also Henry Ridgely Horsey, *The Duty of Care Component of the Delaware Business Judgment Rule*, 19 DEL. J. CORP. L. 971, 978 (1994); Michael Bradley & Cindy A. Schipani, *The Relevance of the Duty of Care Standard in Corporate Governance*, 75 IOWA L. REV. 1, 17-19 (1989); Krishnan Chittur, *The Corporate Director's Standard of Care: Past, Present and Future*, 10 DEL. J. CORP. L. 505, 507-08 (1985).
[132] *See* ALASKA STAT. § 10.06.450 (2006); ARIZ. REV. STAT. ANN. § 10-830 (2007); CAL. CORP. CODE § 309 (West 2007); CONN. GEN. STAT. ANN. § 33-756 (West 2007); FLA. STAT. ANN. § 607.0830 (West

While trust law seems highly relevant to the obligations of directors, agency law may be less relevant to their duties. Directors are not considered agents of the corporation or of the shareholders.[133] According to the Restatement of Agency, "[a]lthough a corporations shareholders elect its directors and may have the right to remove directors once elected, the directors are neither the shareholders' nor the corporation's agents as defined in this section, given the treatment of directors within contemporary corporation law in the United States."[134] The Restatement further explains "corporation law generally invests managerial authority over corporate affairs in a board of directors, not in shareholders, providing that management shall occur by or under the board of directors. Thus shareholders ordinarily do not have a right to control directors by giving binding instructions to them."[135]

Officers, however, would appropriately be considered agents[136] and agency law thus informs the scope of their duties.[137] Officers are designated by the board as agents of the corporation, vested with the power to exercise judgment. For example, as noted by

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

[133] *See, e.g.*, Jones, *supra* note 100, citing Eric W. Orts, *Shirking and Sharking: A Legal Theory of the Firm*, 16 YALE L. & POL'Y REV. 265, 309-312 (1998); Johnson & Millon, *supra* note 117, at 1636.

[134] RESTATEMENT (THIRD) OF AGENCY, § 1.01, cmt 2. The Restatement also states "A director, may of course, also be an employee or officer (who may or may not be an employee) of the corporation, giving the director an additional and separate conventional position or role as an agent. Fellow directors may, with that director's consent, appoint a director as an agent to act on behalf of the corporation in some respect or matter." *Id.*

[135] *Id.*

[136] Jones, *supra* note 100; Johnson & Millon, *supra* note 117, at 1636.

[137] Jones, *supra* note 100; Johnson & Millon, *supra* note 117, at 1636.

Sparks and Hamermesch, a corporate officer has been defined as a person "in whom administrative and executive functions have been entrusted." [138] Furthermore, an officer is someone who is in a position to exercise judgment and discretion in decision making.[139]

Similar to, although less exacting than the duty of care of trustees, the duty of care of agents is described in the Restatement of Agency as "a duty to the principal to act with the care, competence, and diligence normally exercised by agents in similar circumstances. Special skills or knowledge possessed by an agent are circumstances to be taken into account in determining whether the agent acted with due care and diligence."[140] The Comment to this section of the Restatement refers to statutory provisions that may further delineate the duties of a particular agent. In particular, the Comment refers to Section 8.42(a)(2) of the Model Business Corporation Act[141] describing the officer's duty of care as "the care that a person in a like position would reasonably exercise under similar circumstances. . . ."[142] Application of agency principles would, therefore, seem to call for application of a simple negligence standard to the conduct of corporate officers.[143] Furthermore, that standard takes into account the

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[138] Sparks & Hamermesh 1992, supra note 119, at 216. Moreover, "[a]n individual expressly designated as an officer by the board of directors, should, however, be presumed to be empowered to exercise judgment and discretion as to corporate matters, unless it is shown that the board did not intend to vest such authority." *Id*. Similarly, Professor Langevoort notes that "Almost every corporate employee with discretionary responsibilities is an agent, and agency principles are frequently invoked in corporate law disputes." Donald C. Langevoort, *Agency Law Inside the Corporation: Problems of Candor and Knowledge,* 71 U. CIN. L. REV. 1187, 1191 (2003).

[139] Sparks & Hamermesh 1992, *supra* note 119, at 216.

[140] RESTATEMENT (THIRD) OF AGENCY, § 8.08 (2006).

[141] 2 MODEL BUSINESS CORPORATION ACT ANN. § 8.42(a)(2), at 8-262, 266 (3d ed. 2000).

[142] RESTATEMENT (THIRD) OF AGENCY, § 8.08, cmt b (2006).

[143] Johnson, *supra* note 121, at 458-61. *But see* Rock & Wachter, *supra* note128 (arguing that agency and trust law principles have not transferred well to corporate law.)

specific expertise of officers – holding officers with expertise to a standard commensurate with their abilities.[144]

One point of potential divergence in the duty of care analysis between directors and officers seems to be whether the standard of care is one of simple or gross negligence. The Delaware Supreme Court has stated that the applicable standard to be applied to the conduct of directors is one of gross negligence.[145] There is no similar definitive standard, however, with respect to the standard applicable to officers. If agency law does indeed provide the relevant standard, the simple negligence standard seems to be the default standard for officers. Courts could, of course, alter the standard to align it with the standard for directors. As discussed above, some commentators argue that there is no difference between the standard of care of officers and directors. Either way, be the standard simple or gross negligence, agency law allows for consideration of specific expertise and knowledge of the officers when considering liability for breach of the duty of care.

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

Confusing the analysis further is the question of the applicability of the doctrine commonly known as the business judgment rule to the duty of care. The business judgment rule is a presumption that the directors acted in good faith with the reasonable belief that their actions were in the best interest of the corporation.[146] To its credit, the business judgment rule has prevented courts from second-guessing honest, good faith

[144] Professor Langevoort also notes that "an agent is subject to use reasonable efforts to give his principal information which is relevant to the affairs entrusted to him and which, as the agent has notice, the principal would desire to have and which can be communicated without violating a superior duty to a third person." Langevoort, *supra* note 138, at 1194.
[145] Smith v. Van Gorkom, 488 A.2d, 858, 881 (Del. 1985).
[146] *See, e.g.,* Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984); In re Compucom Systems, Inc., Stockholders Litg., C.A. No. 499-N, 14 (Del. Ch. Sept. 29, 2005); Davis v. Louisville Gas & Electric Co, 16 Del. Ch. 157, 142 A. 654 (1928).

business decisions, in cases lacking breach of the duty of loyalty or intentional misconduct allegations.[147] As such, the gross negligence standard applicable to the directors' conduct has emerged from this presumption.[148] That is, absent bad faith plaintiffs must prove behavior amounting to at least a gross negligence standard of culpability in order to state a claim. Facts supporting a claim of simple negligence are not sufficient to overcome the presumption.

The business judgment rule has been a confusing concept in corporate law. The confusion stems from whether it is simply a doctrine that prevents courts from second-guessing good faith business decisions or whether it is a standard of care. For example, according to Professor Bainbridge, the rule is not a rule, but is instead a standard.[149] Furthermore, Professor Bainbridge finds that "the question is not whether the directors violated some bright-line precept, but whether their conduct satisfied some standard for judicial abstention."[150] Regardless, the business judgment rule, together with the gross negligence standard of care, has been applied by the courts to limit the potential liability of directors.[151] Courts appear reluctant to second-guess good faith business decisions. Instead, courts tend to focus the duty of care analysis on the decision-making process, rather than the substantive decision.[152]

One of the justifications given in support of the business judgment rule is that without it, corporations would not be able to attract well-qualified people to serve on

[147] *See, e.g.,* Shlensky v. Wrigley, 95 Ill.App.2d 173 (1968).
[148] *See, e.g.,* Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985).
[149] STEPHEN M. BAINBRIDGE, CORPORATION LAW AND ECONOMICS 283 (2002).
[150] *Id.*
[151] *Id.*
[152] *Id.*

boards.[153] That is, the rewards of serving as a director would not be worth the risk of the liability that might ensue if courts more strictly scrutinized business decisions.[154] In addition, the rule is said to enable corporate boards to undertake business risks.[155] It is feared that without the protections of the rule, directors would be prone to approve only low risk projects when a higher level of risk would be more appropriate.

It is a debated question whether the business judgment rule and the concomitant gross negligence standard of care as established for directors should be applied in a similar fashion to officers.[156] On one hand, Mr. Sparks and Professor Hamermesch argue that the rule should be applied to officers in the same way that it has been applied to directors and that the standard of care for officers should likewise be one of gross negligence.[157] Sparks and Hamermesch then note that the conduct of officers may be more closely scrutinized than directors because they are privy to corporate information.[158] They refer to the Official Comment of Section 8.42 of the MBCA which states that although the standard of care applied to non-director officers with discretionary authority is the same as directors, they are less able to rely on information provided by others and may be required to be more informed about corporate affairs.[159]

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[153] Johnson, *supra* note 121, at 458. *See also* Hal A. Arkes & Cindy A. Schipani, *Medical Malpractice v. the Business Judgment Rule: Differences in Hindsight Bias*, 73 OREGON L. REV. 587, 622 (1994) (discussing rationales justifying the business judgment rule).
[154] *Id.*
[155] *Id*.
[156] Deborah A. DeMott, *Inside the Corporate Veil: The Character and Consequences of Executives' Duties*, Duke Law School Legal Studies Paper Series, Research Paper No. 112, at 16 (2006), available at http://ssrn.com/abstract=918524.
[157] Lawrence A. Hamermesh & A. Gilchrist Sparks III, *Corporate Officers and the Business Judgment Rule: A Reply to Professor Johnson*, 60 BUS. LAW. 865, 865 (2006); Sparks & Hamermesch, 1992, *supra* note 119, at 229.
[158] Sparks & Hamermesch, 1992, *supra* note 119, at 218. Official Comment to Model Business Corp. Act § 8.42.
[159] Sparks & Hamermesch, 1992, *supra* note 119, at 218.

Yet, Sparks and Hamermesch argue that the business judgment rule, as applied to directors, should also apply to officers.[160] They note first that without business judgment rule protection for officers, the policy of the rule – to avoid second-guessing of management – would be imperiled.[161] That is, boards delegate decision making to officers. If the officer is not protected, the board's decision to delegate is therefore not protected. Ultimately, failure to apply the business judgment rule to the decisions of officers would therefore nullify the protection given to directors to delegate decision-making.

Professor Bainbridge also finds that the better view is to apply the business judgment rule to officers. He finds that "[m]ost of the theoretical justifications for the business judgment rule extend from the boardroom to corporate officers."[162] In addition, corporate officers may be even more risk averse than members of the board.[163] Bainbridge further analogizes both the board of directors and top management to production teams and as such "internal governance may be preferable to external review."[164]

Although Sparks and Hamermesch thus argue in favor of business judgment rule protection for officers, their support of the business judgment rule in this context is not unlimited. They recognize the business judgment rule should not apply to officers who

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[160] *Id.* Professor Langevoort also presumes that "officers, like directors, are protected by the business judgment rule, protecting them against claims of simple negligence when a decision turned out poorly." Langevoort, *supra* note 138, at 1203. Langevoort argues that officers have a duty of candor, which "superimpose[s] an obligation to warn directors of risks that are material to the board's level of attention, regardless of their justification." *Id.*
[161] *Id.* at 237.
[162] BAINBRIDGE, *supra* note 149, at 286.
[163] *Id.*
[164] *Id.*

act outside of delegated board authority.[165] Furthermore, just as applied to the behavior of directors, the business judgment rule should not be invoked to protect actions of officers that involve conflicts of interest.[166]

Professor Johnson, on the other hand, disagrees with Sparks and Hamermesch regarding the applicability of the business judgment rule to officers, although agreeing that courts should not second-guess good faith business decisions of officers.[167] Professor Johnson instead argues that a simple negligence as the standard of care should govern the behavior of officers.[168] One point of agreement among Sparks, Hamermesch and Johnson is that although some Delaware courts have assumed that the rule applies to officers, these rulings are not definitive.[169]

Professor Johnson considers the three main justifications for the applicability of the business judgment rule to directors and concludes that these reasons do not justify applicability of the rule to officers. First, Professor Johnson doubts that officers need the protection of the business judgment rule in order to take appropriate risks. Instead, he finds that due to the nature of executive compensation packages, "officers, unlike directors, stand to reap substantial rewards for taking appropriate risks."[170] In addition,

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[165] Lawrence A. Hamermesch & A. Gilchrist Sparks III, *Corporate Officers and the Business Judgment Rule: A Reply to Professor Johnson*, 60 Bus. Law. 865, 876 (May, 2005).
[166] *Id*.
[167] Johnson, *supra* note 121, at 452, 456-7.
[168] *Id.* at 466-70.
[169]Sparks & Hamermesch, 1992, *supra* note 119, at n. 10-12, citing Schreiber v. Pennzoil Co., 419 A.2d 952, 956 (Del. Ch. 1980); Haber v. Bell, 465 A.2d 353, 357 (Del. Ch. 1983); Lewis v. Aronson, 466 A.2d 375, 381 (Del. Ch. 1983), *rev'd on other grounds*, 473 A.2d 805 (Del. 1984); Pogostin v. Rice, No. 6235 (Del. Ch. Aug. 12, 1983), *aff'd*, 480 A.2d 619 (Del. 1984). Professor Johnson has made a similar point, Johnson, *supra* note 121, at 443, citing Cinerama, Inc. v. Technicolor, Inc. 663 A.2d 1156, 1162 (Del. 1995); Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 361 (Del. 1993); Kelly v. Bell, 266 A.2d 878 (Del. 1970); Kaplan v. Centex Corp., 284 A.2d 119, 124-25 (Del Ch. 1971). *See also* In Re Walt Disney Co. Derivative Litig., 2005 Del. Ch. LEXIS 113, aff'd 2006 LEXIS 307 (Del. 2006) ("to date, the fiduciary duties of officers have been assumed to be identical to those of directors").
[170] Johnson, *supra* note 121 at 459.

Professor Johnson argues that officers should face greater risks than directors.[171] They "work for the company full time, possess extensive knowledge and skill concerning company affairs, have access to considerably more and better information than directors, enjoy high company and social status, and exercise great influence over the lives of many people. . . . They should be held to the same standard of care as are all other persons who serve as agents of companies – a duty of ordinary care."[172] Professor Johnson further presents an interesting dilemma that is presented if the business judgment rule also applies to officers. That is, in the case where directors decide to pursue a claim of breach of fiduciary duty against officers, should the courts apply the business judgment rule to the directors' judgment in pursuing the claim against the officers, or should the court apply the business judgment rule to the behavior of officers?[173] To apply the business judgment rule to the conduct of the officers in this context would undermine the board's decision to hold its agent accountable.[174]

Professor Johnson goes on to argue that directors may enter employment agreements with officers to modify the fiduciary duty standard – to either weaken it to a gross negligence standard or eliminate either the duty or monetary liability for breach of duty.[175] In conclusion, Professor Johnson states that "civil liability can remind officers that stockholders and directors likewise expect adherence to basic fiduciary standards, without undeserved refuge in the business judgment rule."[176]

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[171] *Id.* at 460.
[172] *Id.*
[173] *Id*. at 464.
[174] *Id*. at 465.
[175] *Id.* at 466-67.
[176] *Id.* at 469.

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

Yet, it is not clear that gross negligence should be the applicable standard of care. Although we take as a given that the corporate law applies a gross negligence standard in the context of director misconduct, we understand the parameters of scrutiny for officer and executive fiduciary breaches is yet to be resolved. Courts may defer to good faith honest business decisions, as promoted by Professor Johnson,[177] but still hold officers responsible for negligence in the decision-making process. This standard might be justified given the expectations for behavior pursuant to agency law. The agency standard is one of simple negligence which requires courts to evaluate the reasonableness of the care under the circumstances. There are differences in the circumstances between the roles of officers versus directors. For example, unlike directors, officers work for the corporation full-time and have direct access to information. There is less necessity to rely on information provided by others. As such, the simple negligence standard vis-à-vis the decision-making process may help correlate responsibility with liability, given the context of the day-to-day responsibilities of executive officers.

[177] *Id.*

Professor Bainbridge frames the business judgment rule in terms of the need for courts to balance authority and accountability in specific circumstances.[178] He sees the Delaware courts moving in this direction due to variances in the level of judicial review afforded in a particular case which depends "upon the specific context that gives occasion to the boards exercise of business judgment."[179]

Professor DeMott notes that while boards of companies may include directors without operational expertise but officers are required to have expertise.[180] Accordingly, the business judgment rule does not fit neatly to the various roles of executives, especially considering that executives are expected to take actions in accordance with their expertise.[181]

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

D. The Relevance of Expertise

[178] BAINBRIDGE, *supra* note 149, at 283.
[179] *Id.* (quoting McMullin v. Beran, 765 A.2d 910, 918 (Del. 2000)).
[180] DeMott, *supra* note 156, at 25.
[181] *Id.* at 24. DeMott further notes that "the rule appears disconnected from the world of work." *Id* In addition, a question is raised, in the context of executives, regarding whether the rule protects only actions that were authorized. This issue is not as clear as it might at first appear. Instructions that might seem unambiguous to the supervisor may not be unambiguous to the executive attempting to execute the instructions. *Id.* at 25.

There seems to be precedent in corporate law for a contextual approach for determining how closely the courts should scrutinize the obligations of directors. That is, in certain contexts, the courts have considered the specific expertise of directors and the scope of their obligations to the public trust when deciding whether fiduciary obligations have been breached. Part 1 considers this issue in the context of the duty of loyalty and good faith with examination of the decision of the Delaware Chancery court in In Re *Emerging Communications*.[182] Part 2 recalls cases from the 1930s and 1940s, picked up by some contemporary courts in the 1990s, where various state and federal courts wrestled with the duty of care standard applicable to directors of financial institutions. Part 3 returns to recent case law highlighting two Delaware decisions regarding the scope of independence of directors. From these contextual analyses we infer that courts may similarly take a contextual approach to evaluating the surrounding facts and circumstances relevant to the fiduciary obligations of officers. The context of facts and circumstances may ultimately become highly relevant to courts as they delineate how closely they should scrutinize the scope of officers' fiduciary duties with an eye toward correlating liability with responsibility.

1. In re *Emerging Communications, Inc.*

In In Re *Emerging Communications, Inc.*,[183] the board of directors of Emerging Communications, Inc. (ECM) was sued by former minority shareholders alleging breach of the duties of care, loyalty and good faith in the directors' approval of the going private transaction.[184] The going private transaction was found to have been unfair both in the

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[182] *In re* Emerging Commc'n., Inc. S'holder Litig., No. 16415, 2004 Del. Ch. LEXIS 70 (Del. Ch. June 4, 2004).
[183] *Id.*
[184] *Id.* at 35-6.

price paid to the minority shareholders and in the process used to set the price.[185] The court evaluated the nature of fiduciary duties of each board member individually. One of the unique findings of this case involved the fiduciary liability of the members of the board. The court proceeded to find the CEO and Chairman of the board in violation of his duties – he set up the unfair transaction in order to personally benefit.[186]
The court then considered the liability of the director who was the personal attorney of the CEO as well as the company's counsel.[187] This director was held to violate his fiduciary duties because he acted to further his own economic interests.[188] His economic interests and loyalties were tied to those of the CEO.[189]

The most interesting finding of liability was the breach of fiduciary duty of Mr. Muoio, a director who was also an investment banker. Muoio had substantial expertise in finance and in the telecommunications sector.[190] Such expertise prompted the court to find him liable for breach of the fiduciary duty of loyalty and/or good faith because he should have recognized that the transaction was unfair.[191] According to the court, this director was held liable "because he voted to approve the transaction even though he knew, or at the very least had strong reasons to believe, that the $10.25 per share merger price was unfair."[192] Thus, based on his experience, Muoio was obligated, although a majority of the board was not so obligated, to recognize that the merger price was unfair

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[185] *Id.* at 42-137.
[186] *Id.* at 140.
[187] *Id.* at 121.
[188] *Id*. at 122-3.
[189] *Id*. at 142.
[190] *Id.* at 143.
[191] *Id.* *See also* Harvey L. Pitt, *The Changing Standards by Which Directors Will Be Judged*, 79 ST. JOHN'S L. REV. 1 (2005); E. Norman Veasey, *Musings from the Center of the Corporate Universe*, 7 DEL. L. REV. 163, 172 (2004).
[192] Emerging Commc'n., 2004 Del. Ch. LEXIS 70, at *143.

and to vote against the transaction.[193] In other words, the court held Muoio liable because his experience should have alerted him to the unfairness of the price. On the other hand, the court did not find that the remaining, less-experienced, directors had violated their fiduciary duties[194] - presumably because they did not possess special knowledge which would have put them on notice of the unfairness of the transaction.

It is also worth noting that Muoio was held liable for breach of the duty of loyalty and/or good faith. The parameters of the duty of good faith had not yet been decided in Delaware and the court did not find it necessary to determine whether good faith was a stand alone duty or linked to another duty. Furthermore, due to the Section 102(b)(7)-type provision in ECM's articles of incorporation protecting ECM's directors from monetary liability for breach of the duty of care, the *ECM* court focused its analysis on the duty of loyalty and/or good faith rather than the duty of care.[195]

This case is particularly interesting in the approach the court used to correlate liability with knowledge and expertise.[196] To the extent Muoio knew or should have known that the price set by the CEO was unfair, it follows that liability should ensue. Yet, the case is troubling to the extent it singles out a director for his personal expertise. There seems to be serious risk that persons with the specific expertise needed in a corporate boardroom may shy away from serving on boards if they are held to a higher

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[193] *Id.* at 144-5.
[194] *Id.* at 148. See also Canadian Commercial Workers Industry Pension Plan v. Alden, 2006 Del. Ch. LEXIS 42, n.54 citing *ECM* and noting that *ECM* held "that a director with *financial* expertise and 'in a unique position to know' should have argued more vociferously that the $10.25 price of a proposed transaction was unfair . . . and that the director was not independent") (emphasis in original).
[195] See Muir & Schipani, *supra* note 102, at 447-452 for further discussion of the duty of loyalty and/or good faith as discussed in *ECM*.
[196] *See* Pitt, *supra* note 191, at 4-5 (discussing *ECM* noting that the case implies that "those with special expertise need to take care if they wish their utilization of and reliance on outside experts to exculpate them from liability"); *but see* E. Norman Veasey & Chrstine T. Di Guglielmo, *What Happened in Delaware Corporate Law and Governance from 1992-2004? A Retrospective on Some Key Developments*, 153 U. PA. L. REV. 1399, 1445-1448 (2005) (noting that *ECM* should not be interpreted to mean that those with more expertise will be held to a higher standard).

standard of care. Conversely, from a policy perspective, board members should not be encouraged to check their expertise at the door when entering the boardroom. The shareholders, presumably elected the board members to utilize their expertise and experiences in making corporate decision.

As mentioned above, *ECM* was decided as a loyalty and good faith case rather than a due care case. The company's articles of incorporation exonerated the board members from liability for breach of the duty of care. If a similar case alleging a due care violation were to be brought against an officer possessing expertise which establishes that he or she should have known that the decision was not in the best interest of the corporation, it seems that such knowledge would be relevant to the surrounding facts and circumstances of the decision-making process. Although it may be appropriate to apply business judgment rule deference in avoiding second-guessing of good faith, honest business decisions, it would still be fair to consider the surrounding facts and circumstances as they affect the decision-making process. As made clear by the Delaware Supreme Court in *Smith v. Van Gorkom*[197] and more recently in In Re *Walt Disney*,[198] regardless of the business judgment rule presumption, the duty of care requires gathering of all reasonably available information before making a business decision. Reasonably available information would include information correlated to expertise and responsibility.

2. Bank Director Cases

Another area of corporate law where the courts have found specific contexts relevant to the fiduciary duty analysis of directors involves the obligations of bank

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[197] Smith v. Van Gorkom, 488 A.2d. 858 (Del. 1985).
[198] In re The Walt Disney Co. Derivative Litig., 2006 Del. LEXIS 307 (Del. 2006).

directors, particularly in the days preceding the availability of deposit insurance.[199] The basic fact pattern of these cases often involved intentional wrongdoing by officers or other members of management that went undetected by the board. Under these circumstances the board members were held liable for failure to control and supervise the affairs of the bank. Although case law does not directly hold that there is a higher standard of care applicable to directors of financial institutions, the courts did find liability for the failure of bank directors to exercise the ordinary care and diligence of an ordinarily prudent person acting in similar circumstances.[200] These circumstances included added responsibility for depositors' accounts. This responsibility required the bank directors to exercise reasonable control and supervise the affairs of the banks.

For example, in *Atherton v. Anderson*,[201] the Sixth Circuit Court of Appeals, in 1938, held that one of the purposes of the bank is to safely hold the money of the depositors. *Atherton* involved a fraud perpetrated by the president and cashier of the bank. The directors were sued by the receiver for violation of their duty of due care. The court noted that depositors had a right to expect that the directors maintain "reasonable control and supervision over the affairs of the Bank, especially over its larger and more important ones."[202] The court further noted that a national bank is not a private

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[199] The Federal Deposit Insurance Corporation was established by the Congress in 1933, during the Great Depression. *See* Cindy A. Schipani, *Should Bank Directors Fear FIRREA: The FDIC's Enforcement of the Financial Institutions Reform, Recovery and Enforcement Act*, 17 J. CORP. L. 739, 748-51(1992).
[200] *See e.g.*, Atherton v. Anderson, 99 F.2d 883 (6th Cir. 1938), referring to the standard articulated in Briggs v. Spaulding, 141 U.S. 132 (1891). *See also* FDIC v. Mason, 115 F.2d 548 (3d Cir. 1940); Bourne v. Perkins, 42 F.2d 94 (8th Cir. 1930); Ringeon v. Albinson, 35 F.2d 753 (D. Minn. 1929); Cory Mann George Corp. v. Old, 23 F.2d 803 (4th Cir. 1928); Gamble v. Brown, 29 F.2d 366 (4th Cir. 1928); Mullins v. DeSoto Sec. Co., 56 F. Supp. 907 (W.D. La. 1944); Proksch v. Bettendorf, 257 N.W. 383 (Iowa 1934); Goodwin v. Simpson, 197 N.E. 403 (Mass. 1922); Barber v. Kolowich, 275 N.W. 797 (Mich. 1937); Trembert v. Mott, 261 N.W. 109 (Mich. 1935); Liffiton v. Nat'l Sav. Bank, 44 N.Y.S. 2d 770 (N.Y. App. Div. 1943); Gallin v. Nat'l City Bank, 281 N.Y.S. 795 (N.Y. Sup. Ct. 1935); Anderson v. Bundy, 171 S.E. 501 (Va. 1933); Williams v. Fidelity Loan & Sav. Co., 128 S.E. 615 (Va. 1925).
[201] Atherton v. Anderson, 99 F. 2d 883 (6th Cir. 1938).
[202] *Id.*

corporation in which shareholders alone are interested but a quasi-governmental agency.[203]

In *Billman v. State Deposit Insurance Fund Corp.*,[204] the court upheld a jury instruction regarding a stricter standard of care applicable to the duty owed by the directors of a savings and loan institution. The reason behind the stricter standard was the entrustment of funds belonging to the general public. The appellate court found that due care should be as compared to officers and directors of that type of enterprise – which includes the responsibility for the savings of others.[205]

Application of a higher standard of liability to bank directors has been challenged and upheld in New York. In *Resolution Trust Corp. v. Gregor*[206] the court addressed the view presented by the defendant that the older bank director cases have "lost their vitality" in the wake of the business judgment rule.[207] The court disagreed finding no precedent for applying the business judgment rule to bank director cases.[208] Then, although acknowledging defendant's assertion that courts rarely cite the old rule to apply a higher standard of liability to bank directors, the court did not find a compelling reason to rewrite law that has "remained unchanged for at least one hundred years."[209]

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[203] *Id. See also* Hopkins Fed. Sav. & Loan Ass'n v. Cleary, 296 U.S. 315, 328 (1935) (explaining that building and loan associations in Wisconsin are "quasi public corporations… with powers and immunities peculiarly their own.").

[204] Billman v. State Deposit Ins. Fund Corp., 593 A.2d 684 (Md. Ct. Spec. App. 1991). *See also* FDIC v. Stanley, 770 F. Supp. 1281, 1310-11 (N.D. Ind. 1991) where the court noted the requirement that bank directors exercise reasonable control and supervision over the affairs of the bank, but further noting that bank directors are not insurers or guarantors.

[205] Arguments that the situation rather than the standard applied is what distinguishes the liability of bank directors from that of other directors have early roots. *See, e.g.* C. B & S. B, *The Standard of Care Required of Saving Bank Directors*, 25 YALE L.J. 2, 141-43 (1915) (commenting on director liability, "different kinds of business vary in the degree of care required to constitute reasonable prudence on the part of those conducting them.").

[206] Resolution Trust Corp. v. Gregor, 872 F. Supp. 1140, 1151 (E.D.N.Y. 1994)

[207] *Id.*

[208] *Id.*

[209] *Id.*

More recently, the court in *FDIC v. Bober*[210] faced a similar challenge. Refusing to weaken the standard applied to bank directors, the court opined, "if the legislature intended to completely harmonize the standards to which bank directors and corporate directors are held, it presumably would have used exactly the same language."[211]

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

3. Contemporary Cases on Independence

Finally, a third context relevant to our inquiry is the deeper contextual analysis entertained by the Delaware courts when the independence of directors is at issue. For example, in In re *Oracle Corp. Derivative Litigation*,[212] the Delaware Chancery court was asked to decide whether the special litigation committee formed to determine whether the shareholders' derivative suit should be allowed to proceed was indeed an independent committee.[213] The court found that the independence issue "turns on whether a director is, for any substantial reason, incapable of making a decision with only

[210] FDIC v. Bober, 2002 U.S. Dist. LEXIS 13231 (D.N.Y. 2002)
[211] *Id.* at 8.
[212] *In re* Oracle Corp. Derivative Litig.,824 A.2d 917 (Del. Ch. 2003).
[213] *Id.* at 929.

the best interests of the corporation in mind."[214] In this case, the court not only considered whether the independent directors were directors of the company at the time of the facts giving rise to the dispute (they were not), but also delved further into the inter-relationships between members of the special litigation committee and the defendant directors. Here the court found that all directors – both special litigation committee members and defendant directors – had significant ties to Stanford University.[215] These ties to Stanford were enough to thwart the independence of the special litigation committee. The court held that the facts gave reasonable doubt as to whether the special litigation committee might be unable to render an impartial decision.[216]

Similarly, the Delaware Chancery Court in In re *eBay Shareholders Litigation*, found itself deciding whether a special litigation committee was independent.[217] Again the standard for determining independence was whether the special litigation committee could be objective and impartial.[218] There was significant concern that because the directors of the special litigation committee served at the pleasure of the defendant directors – the defendant directors were also majority shareholders – it was unlikely that these special litigation committee members could be impartial.[219] Moreover, the special litigation committee members held options that required additional years of board service before vesting. If the committee decided that the litigation should proceed against the defendant directors, the members of the special litigation committee risked the possibility

[214] *Id.* at 920 (citing Parfi Holding AB v. Mirror Image Internet, Inc., 794 A.2d 1211, 1232 (Del. Ch. 2001 *rev'd in part on other grounds*, 817 A.2d 149 (Del. 2002)).
[215] *Id.* at 942-7.
[216] See Muir & Schipani, *supra* note 102 for further details concerning these relationships.
[217] In re eBay S'holders Litig., No. 19988-NC, 2004 Del. Ch. LEXIS 4 (Del. Ch. Feb. 11, 2004).
[218] *Id.* at 11.
[219] *Id.*

that the defendant directors would terminate them from their positions as directors.[220] If these directors lost their directorships, their options would not vest.[221] Millions of dollars, in the pockets of the so-called independent directors, were at stake.[222]

These cases demonstrate that the Delaware courts are willing, in what they believe to be appropriate circumstances, to dive deeply into surrounding circumstances when making decisions relevant to corporate directors' obligations. It seems fair to say that these cases may signal the direction of future rulings when questions of officer liability are directly presented. That is, if *Oracle* and *eBay* are representative, there seems to be a trend for courts to look beneath the surface of the issue presented and consider all the facts and circumstances surrounding the issue.[223] Such an approach is consistent with correlating liability with responsibility.

IV. Correlating Corporate Officer Responsibility and Liability

Federal and state regulatory regimes have showed increased interest in defining the obligations of corporate officers. In Part II, we analyzed ERISA's approach to correlating fiduciary obligation with liability in benefit plans. In our examination of corporate law in Part III, we identified three opportunities for correlating officer duty of care obligations with potential personal liability. In this Part we consider whether

[220] *Id.* at 9.
[221] *Id.* at 11.
[222] *Id.*
[223] *See also* Beam v. Stewart, 845 A.2d 1040, 1052 (Del. 2004) (discussing allegation necessary to "create reasonable doubt about an outside director's independence"); *In re* Compucom Sys., Inc. Stockholders Litig., C.A. No. 499-N, 24 (Sept. 29, 2005) ("The court recognizes that under certain circumstances, professional, financial, and personal relationships of directors may preclude a finding of independence"). *See also* Lisa M. Fairfax, *Sarbanes-Oxley, Corporate Federalism, and the Declining Significance of Federal Reforms on State Director Independence Standards*, 31 OHIO N. U. L. REV. 381, 400-04 (2005) (discussing *Oracle* and *Stewart* and arguing that the Delaware Supreme Court's decision in *Stewart* retreated from giving significant weight to personal relationships when determining the independence of the directors).

corporate law is likely to confront issues similar to those that have arisen under ERISA. We also examine whether ERISA's approach to the issues offers any guidance to state courts as they increasingly consider the fiduciary obligation of corporate officers. We begin with the problem of how to identify which specific corporate officers should face potential liability for particular actions. We next turn to the role expertise should play in evaluating duty of care obligations. Then we discuss the applicability of the business judgment rule to decisions made by corporate officers. Finally we address the challenges posed by conflicts of interest.

A. Identification of Responsible Corporate Officers

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

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

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

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

The corporate principle that every officer has fiduciary obligations does not so neatly correlate responsibility with liability. Nor are the concerns of individual liability limited to the types of financial fraud seen in some of the recent corporate scandals. Consider the situation where a corporate officer, the Vice President of Product Development, negligently ignores signals that there is a safety issue in a new product. The Vice President of Manufacturing may have sufficient experience to recognize that the product, if produced according to specifications, could result in the death or serious injury of customers. Perhaps the Vice President of Sales is aware that a competitor's past product had similar flaws. The Vice President of Facilities may have no logical reason at all to know of the potential safety problem but actually is aware of it because he has friends in the Product Development department who are concerned about the issue. The CFO may be so consumed with ensuring that the company's financials meet accounting and securities standards that she has no knowledge of any of the details of the new product, let alone any awareness that it poses a potential safety hazard.

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

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

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

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

This approach also fits neatly with importation of agency law in defining the scope of an officer's fiduciary duty. As mentioned above, an officer may be defined as an agent appointed by the board with the power to exercise discretion and judgment. In the exercise of that discretion, the duty of care, as described in the Model Business

Corporation Act, requires the exercise of "the care that a person in a like position would reasonably exercise under the circumstances."[224]

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

B. The Role of Expertise

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

Again consider the hypothetical committee charged with investing plan assets. A fiduciary on that committee may have sufficient financial acumen to perfectly correlate the plan's investment in financial vehicles of various durations with the expected

[224] 2 Model Business Corporation Act Ann. § 8.42(a)(2), at 8-262,-266 (3d ed. 2000).

maturation of the plan's benefit payment obligations. For a small defined benefit plan, however, the expense in making and overseeing such complex investments, including the cost of properly compensating a plan fiduciary with such expertise, may grossly exceed the gains from such an investment strategy. If, however, the duty of care analysis takes into account the investment expertise of a fiduciary charged with discretion over plan assets, the fiduciary arguably may be required to utilize that investment expertise.

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

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

Particularly as applied to officers, corporate law might benefit by establishing the duty of care based on the context of responsibilities. Individual expertise would enter the analysis if relevant to the context. Thus, if individual officers are being hired and paid to use their expertise, then expertise would be important to the duty of care determination.

This is consistent with the agency law duty which specifically calls for consideration of special skills and expertise.[225] It would be important to not encourage executive officers to turn a blind eye toward issues they are hired to address. Conversely, the contextual approach would avoid the over burdensome outcome of imposing an obligation to use expertise in an area outside of an individual officer's assigned responsibilities.

C. The Applicability of the Business Judgment Rule

Interesting parallels, as well as some important differences, exist between the business judgment rule and the deferential standards ERISA utilizes to protect plan fiduciaries. The business judgment rule applies to decisions of the board of directors so long as the decision meets the basic requirements of the rule. Although specific factors, such as the existence of a conflict of interest, are relevant in deciding whether to apply the rule, in general, the type of decision being evaluated does not impose a threshold for application of the business judgment rule.[226] And, there is a debate over whether it is a rule, a doctrine, or a standard of care.[227] In contrast, ERISA's deferential standards are context specific. In this article we considered two of those deferential standards - the presumption in favor of ESOP investments in company stock and the use of the arbitrary and capricious standard of review for determinations of plan benefit eligibility. And, the ERISA approach clearly is to utilize deferential standards of review rather than modifications to the fiduciary duty of care.

[225] RESTATEMENT (THIRD) OF AGENCY, § 8.08.
[226] Here we are considering ordinary business decisions, or the "traditional business judgment rule," as defined by Brainbridge, *supra* note 149, at 284. Brainbridge notes, however, two variants of the rule – one applied in the sale of business and the other which he calls a "conditional" business judgment rule in the context of takeover defenses. *Id.*
[227] *See supra* text accompanying notes 149-52.

The theoretical justifications, including avoidance of second-guessing and risk aversion,[228] that support the use of the business judgment rule to evaluate board decisions also apply in the ERISA context. The concern that failure to apply a deferential standard of review to officer decisions would nullify the protection given to boards that delegate decision-making has particular resonance with the ERISA experience. In the context of decisions regarding benefit eligibility, a key determinant of whether a deferential review standard will be used is whether the benefit plan grants interpretative discretion to the fiduciary. Corporate officers have the responsibility to put into effect the strategic plans and policies formulated by the board of directors. An ERISA fiduciary charged with determining benefit eligibility has responsibility to ensure that benefit plan participants receive the benefits contemplated by the plan sponsor, but only those benefits.

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

In our initial analysis we argued that a focus on discretion would justify applying the duty of care regarding safety in the product development process to the VP of product development. At minimum, the VP would be expected to use the expertise appropriate given the context of the company and its product development function. Again we assume the VP negligently permitted the product to go forward. The question we now

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[228] *See supra* text accompanying notes 153-95 discussion.

confront is whether that VP's decisions regarding the product should be entitled to the presumption of the business judgment rule or some other deferential standard of review.

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

D. The Challenge of Conflicts of Interest

Before drawing together the ERISA and corporate analyses on conflicts of interest, it is useful to review the traditional trust law standard that applies to situations involving a conflict of interest. Historically, that standard has been a harsh one so that if a fiduciary acts in a transaction in which her personal interest conflicts with the trust beneficiary's interest, the transaction is conclusively presumed the transaction to be invalid.[229] Exceptions exist to permit specific categories of interest transactions and the harshness of the standard has garnered some criticism.[230] But, trust law's presumption against an interested fiduciary is a strong one.

[229] John H. Langbein, *Questioning the Trust Law Duty of Loyalty: Sole Interest or Best Interest?*, 114 YALE L.J. 929, 931 (2005).
[230] *Id.* at 963-79.

In contrast, as noted above, ERISA explicitly allows agents of plan sponsors and of other fiduciaries to act as ERISA fiduciaries.[231] Thus, the acceptance of conflicted fiduciaries is in tension with ERISA's fiduciary obligation of loyalty. The extent of the structural problem created by ERISA is evidenced in the continuing difficulties confronted by courts in reviewing benefit eligibility determinations.

Whether the decision regarding benefit eligibility is made by an insurer or the plan sponsor, the approval of a benefit entitlement typically is directly contrary to the financial interests of the fiduciary charged with making the determination. An insurer who denies benefits has lower costs than one that approves benefits. A plan that pays benefits costs more to sponsor than one that denies benefits. The courts continue to struggle with how such an intractable conflict should affect application of the deferential standard of review.[232]

In our previous work we analyzed the need for protection of ERISA fiduciaries when those fiduciaries make decisions that affect investments in company-sponsored investment plans, such as 401(k) plans.[233] There we advocated the use of a two-tiered review approach. Where the decisions do not involve employer stock or other serious conflicts, we believe the appropriate standard to be "an objective standard requiring [the fiduciary] (1) to employ proper methods to investigate, evaluate and structure the investment; (2) to act in a manner as would others who have a capacity and familiarity with such matters; and (3) to exercise independent judgment when making investment

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[231] *See supra* text accompanying note 88.
[232] *See* supra text accompanying notes 80-95 for a discussion of the standard and the controversy.
[233] Muir & Schipani, *supra* note 81, at 354-56.

decisions."[234] Where intractable conflicts of interest inhere in the fiduciary decision, we call for the use of stricter review.[235]

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

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

[234] *Id.* at 355 (quoting Ulico Cas. Co. v. Clover Capital Mgmt., Inc., 335 F. Supp 2d 335, 340 (N.D.N.Y. 2004).
[235] *Id.* at 356.

analysis used for corporate boards, that courts will need to use a contextual approach to determine the effect conflicts of interest should have on the review of corporate officer actions.

V. Conclusion

We agree with other commentators that the fiduciary duty of officers is not well-developed in corporate law.[236] The current trend seems to be in the direction of imposing liability commensurate with responsibility. The scandals of the late 1990s and early 2000s, the enactment of SOX[237] in response thereto, and a new wave of corporate scandals involving backdating of stock options, make it clear that upper management misconduct is in the spotlight.

In response, state law seems to be ratcheting up the scrutiny of corporate behavior. There is precedent dating back to the financial failures of the 1930s for turning up the heat in the wake of financial scandals.[238] Today, we see the duty of loyalty and good faith imposing a heavier burden on a director who, due to his expertise under the circumstances, should have known better than to let the fraud occur.[239] We also see the Delaware courts highly scrutinizing personal and business relationships as they relate to the ability of a board member to render impartial judgments.[240] It would not be much of a stretch for courts to further scrutinize the role of officers in light of their obligations to the corporation.

[236] *See* notes 117-19, *supra* and accompanying text.
[237] Sarbanes Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified as amended in scattered sections of sections 11, 15, 18, 28, and 29 U.S.C.)
[238] *See* notes 199-203, *supra* and accompanying text.
[239] *See* notes 190-94, *supra* and accompanying text.
[240] *See* notes 212-23, *supra* and accompanying text.

As the corporate law courts further define the scope of fiduciary duties in the executive suite, the experience of the courts in implementing ERISA's fiduciary standards serves as both a guide and as a warning. ERISA has linked liability with the acts of responsible fiduciaries by using the touch stone of discretion.[241] Similarly, discretionary authority and responsibility can serve as a principle to determine which corporate officers should be subjected to scrutiny for particular wrongdoing.[242] Second, in determining whether an ERISA fiduciary has breached the standard of care, the courts have had to consider the role expertise should play in the analysis. Although this remains unsettled, we believe that the proper approach is to take into account the nature of the benefit plan at issue and the level of sophistication of investments.[243] Agency law envisions holding agents to the standard of care of the reasonable person acting in similar circumstances, taking into account special expertise.[244] We argue that these considerations call for application of a similar, contextual approach, to the role of expertise in determining the standard of care applied to corporate officers.

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

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[241] *See* notes 17-21 *supra* and accompanying text.
[242] *See supra* Part IV.A.
[243] *See supra* Part IV.B.
[244] *See* notes 140-43, *supra* and accompanying text.

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