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# Reality Check on Officer Liability

By Lyman Johnson\* and Robert Ricca\*\* | [Author Bios](#)

*This article addresses the fiduciary duties of corporate officers. Responding to a critique that recent scholarly analyses of officers depart from reality, it argues that, on a variety of grounds, those analyses are more realistic than the critique and provide doctrinal coherence and advance the goal of meaningful executive accountability. The divergent governance functions of directing versus managing are described and it is argued that those disparate roles should matter for fiduciary duty analysis. No great outbreak of litigation should be expected if officers are held to a stricter duty of care than directors because boards of directors, not courts, likely will resolve the vast majority of disputes concerning officer breaches of duty. The ex ante and ex post roles of fiduciary duties are emphasized, and the need for the Delaware legal community to more fully address more fully officer duties is noted, lest the federal government emerge as the chief regulator of senior management, a role central to corporate governance.*

## I. INTRODUCTION

In the February issue of *The Business Lawyer*,<sup>1</sup> Paul Graf broke into the halting conversation about officer liability. He argued, in essence, that Lyman Johnson and others have advanced an analysis of corporate officers that, while perhaps theoretically sound, “departs from reality.”<sup>2</sup> We welcome Mr. Graf’s voice in the still-unfolding development of this area of law. But in this article we argue that, for a number of reasons, it is Mr. Graf’s views that are unrealistic in today’s world of corporate life and corporate law. Adoption of his position, which we understand is echoed by many in the corporate community, would lead corporate law astray, and would serve to weaken the role of fiduciary duties both in guiding officers and sanctioning their misconduct.

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1. Paul Graf, *A Realistic Approach to Officer Liability*, 66 *BUS. LAW.* 315 (2011).

2. *Id.* at 321 (the “theoretical analysis departs from reality”). Mr. Graf also takes issue with certain points made by other thoughtful commentators, Lawrence A. Hamermesh & A. Gilchrist Sparks III, *Corporate Officers and the Business Judgment Rule: A Reply to Professor Johnson*, 60 *BUS. LAW.* 865 (2005).

Part II of this article highlights the sharply distinct roles of directors and officers in our system of corporate governance—i.e., directing versus managing. This foundational difference invites the question of whether such disparate roles should, nonetheless, result in equivalent fiduciary duties, as Mr. Graf asserts. Part III contends that the divergent functions of directors and officers should matter for fiduciary duty analysis. Corporate officers, unlike directors, are agents of the corporation, and therefore agency law supplies the default duties for officers, subject to possible judicial or contractual modification.

Part IV argues that directors, not courts, likely will resolve the vast majority of disputes concerning officer breaches of duty. Consequently, there will be no great outbreak of litigation *ex post* and courts will continue, as now, to address far more director than officer cases. Moreover, for a variety of reasons we identify, a stricter standard of care for officers than for directors will not distort or have adverse effects on managerial behavior. Part V sketches the important but oft-neglected role that meaningful officer fiduciary duties can play in shaping officer conduct *ex ante*. Part VI explains how Mr. Graf collapses many established distinctions in current corporate law analysis, and shows how he offers less a critique of officer liability than an unwarranted broadside against judicial review of fiduciary duties more generally. Part VII concludes by describing how the federal government—notably the Securities and Exchange Commission (“SEC”)—is now the chief legal regulator of officers, not Delaware courts or state corporate law. Necessarily, with widespread officer wrongdoing in contemporary business society showing no sign of abating, some legal body must articulate and enforce legal rules for officers. The question for members of the Delaware legal community is whether they will contribute to this enterprise or quit the field.<sup>3</sup>

## II. THE UNDENIABLY DIFFERENT GOVERNANCE FUNCTIONS OF DIRECTORS AND OFFICERS

While serving as a corporate officer can lead to fame (think Jack Welch at GE, Steve Jobs at Apple, and Richard Branson at Virgin), or infamy (see Jeffrey Skilling and Andrew Fastow at Enron, Dennis Kozlowski at Tyco, Tony Hayward at BP, or the senior managers of the Murdoch news empire), one would be hard-pressed to come up with similar lists of notoriety for members of boards of directors. This distinction reflects the central corporate governance role of corporate officers. Unfortunately, however, certain state legislators, judges, practitioners, and aca-

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3. By “members of the Delaware legal community,” we do not mean only judges who, after all, can only adjudicate those cases and address those claims brought before them. We mean as well, if not more significantly, plaintiffs’ lawyers who routinely fail to differentiate legally claims against officers from claims against directors. See Lyman Johnson & Dennis Garvis, *Are Corporate Officers Advised About Fiduciary Duties?*, 64 *BUS. LAW.* 1105, 1109 & nn.27–29 (2009) (describing the too-late effort of plaintiffs’ counsel in the *Disney* litigation to sharpen their focus on officers); see also *infra* note 118. We also mean corporate lawyers who may spend inadequate time counseling officers about fiduciary duties. See Johnson & Garvis, *supra*, at 1109–10; Lyman P.Q. Johnson & Robert V. Ricca, *(Not) Advising Corporate Officers About Fiduciary Duties*, 42 *WAKE FOREST L. REV.* 663, 670–71 (2007).

demics fail to appreciate the myriad substantive differences between the roles of corporate officers and directors, and instead lump officers and directors together as “management” for purposes of analyzing fiduciary duty obligations.<sup>4</sup> This conflation is problematic. A realistic analysis of the fiduciary duty obligations of officers as compared to the well-established fiduciary duty obligations of directors requires that we first acknowledge the very different governance roles of officers as compared to directors.

### A. DIRECTING VERSUS MANAGING

Since it is not practical, or even possible, for the shareholders of a corporation with widely dispersed ownership to oversee the management of the business, the board of directors serves as an “intermediary” between the business owners (the shareholders) and the business managers (the officers).<sup>5</sup> Boards of directors ensure that shareholder wealth is enhanced through providing guidance on business strategy and through oversight and monitoring of the officers in their management of the business.<sup>6</sup> Mr. Graf overlooks this intermediary role of the board, assuming instead that boards of directors actively manage the business.<sup>7</sup> While corporate statutes provide directors with management authority,<sup>8</sup> in reality, given the “size and complexity of many modern corporations,”<sup>9</sup> boards of directors cannot and do not “manage” the business and affairs of the corporation.<sup>10</sup> Instead, the “norm in corporate America” is that the board delegates its management authority to the officers.<sup>11</sup>

4. See Lyman P.Q. Johnson & David Millon, *Recalling Why Corporate Officers Are Fiduciaries*, 46 WM. & MARY L. REV. 1597, 1599–1600 (2005).

5. See AM. LAW INST., 1 PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS pts. III & III-A (1994) [hereinafter ALI PRINCIPLES]; see also ABA CORPORATE LAWS COMM., CORPORATE DIRECTOR'S GUIDEBOOK 1 (6th ed. 2011) [hereinafter GUIDEBOOK].

6. See ALI PRINCIPLES, *supra* note 5, § 3.02(a) & cmt. d; see also GUIDEBOOK, *supra* note 5, at 1.

7. Graf, *supra* note 1, at 319, 324–25 (“directors have primary responsibility for managing the corporation”); see also *infra* note 13 and accompanying text.

8. See DEL. CODE ANN. tit. 8, § 141(a) (2001) (“the business and affairs . . . shall be managed by or under the direction of a board of directors”); see also MODEL BUS. CORP. ACT § 8.01(b) (2011) (“the business and affairs of the corporation shall be managed by or under the direction, and subject to the oversight, of its board of directors”).

9. See R. Franklin Balotti & Megan W. Shaner, *Safe Harbor for Officer Reliance: Comparing the Approaches of the Model Business Corporation Act and Delaware's General Corporation Law*, 74 LAW & CONTEMP. PROBS. 161, 169 (2011).

10. See ALI PRINCIPLES, *supra* note 5, § 3.02 cmt. a; see also GUIDEBOOK, *supra* note 5, at 2 (“The key challenge for directors is to oversee the corporation's activities and strategy by utilizing effective oversight processes and making informed decisions, without becoming day-to-day managers.”); MODEL BUS. CORP. ACT § 8.01(b) & cmt., at 8-4 (“In some closely held corporations, the board of directors may be involved in the day-to-day business . . . . But in many other corporations, the business and affairs are managed ‘under the direction, and subject to the oversight, of’ the board of directors, since operational management is delegated to executive officers and other professional managers.”).

11. Thuy-Nga T. Vo, *To Be or Not to Be Both CEO and Board Chair*, 76 BROOK. L. REV. 65, 68 (2010); see also Johnson & Millon, *supra* note 4, at 1621 (“[U]ntil the early 1970s, most corporate statutes provided that boards of directors actually were to ‘manage’ the corporation. . . . Legal form eventually yielded to institutional reality for directors, as corporate statutes were amended to provide that the management function need only be under the board's ‘direction.’” (citations omitted)).

In delegating its management authority, directors adopt corporate bylaws and approve initial board resolutions granting the officers vast and wide-reaching operational powers.<sup>12</sup> Mr. Graf's assertion that "the board controls the level of specificity of each delegation" is simply inaccurate.<sup>13</sup> In reality, directors only intervene or limit officer discretion on major corporate decisions, such as: change of control or financing transactions; acquisitions and dispositions of material assets; major changes in plans and strategies; and changes involving accounting, financial statements, and internal controls and procedures.<sup>14</sup> Since the board only intervenes in management functions for major issues, the directors focus their attention on board oversight and monitoring functions.<sup>15</sup> The directors oversee and monitor financial performance, officer managerial performance, compliance with legal obligations and corporate policies, and evaluation and design of appropriate risk management structures.<sup>16</sup> Perhaps the most important director oversight functions include the selection and appointment of qualified individuals to serve as the corporate officers, followed by the periodic evaluation of those officers and the determination of executive compensation.<sup>17</sup>

With directors intervening only on major issues, the officers are left with primary responsibility to manage the day-to-day operations of the business. Using the broad delegation of authority from the board, executive officers "[d]etermine and formulate policies and provide [the] overall direction of companies."<sup>18</sup> Typi-

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12. See DEL. CODE ANN. tit. 8, §§ 141(a), 142(a)-(b) (2001); MODEL BUS. CORP. ACT §§ 8.01(b), 8.40 & 8.41; see also Johnson & Millon, *supra* note 4, at 1605 n.24. For example, see also the Massey Energy Company bylaws, which granted the CEO, subject to the power and authority of the board, "general supervision, direction and control of the officers, employees, business and affairs of the Corporation." Massey Energy Co., Restated Bylaws (Exhibit 3.2, Form 8-K), Article IV, § 4.01 (Dec. 3, 2010), available at <http://www.sec.gov/Archives/edgar/data/37748/000119312510275690/dex32.htm>.

13. Graf, *supra* note 1, at 319. On the other hand, Mr. Graf also raises a concern that "[i]f directors divest themselves of responsibility by delegating substantial discretion to officers without meaningful guidance, and then neglect to monitor the exercise of that discretion, should directors not be held accountable at least to the same extent as officers? To do otherwise is to grant directors a license to shirk responsibility with impunity." *Id.* at 320. We disagree with this concern; the director monitoring function is subject to well-established fiduciary duty obligations, and the standard of liability for officers in carrying out their management functions should not change those standards.

14. See ALI PRINCIPLES, *supra* note 5, § 3.02; see also GUIDEBOOK, *supra* note 5, at 11; Vo, *supra* note 11, at 68 n.11 (citing Lynn A. Stout, *On the Proper Motives of Corporate Directors (or, Why You Don't Want to Invite Homo Economicus to Join Your Board)*, 28 DEL. J. CORP. L. 1, 18 (2003) (explaining that after directors select executives and employees to run daily operations, the directors intervene in daily operations only on major issues)).

15. See Johnson & Millon, *supra* note 4, at 1602; see also MODEL BUS. CORP. ACT § 8.01(b) & cmt., at 8-4, 8-5; ALI PRINCIPLES, *supra* note 5, § 3.02 cmt. d ("The director oversight function refers 'to general observation and oversight, not active supervision or day-to-day scrutiny.' . . . This oversight function is usually performed, not directly by actively supervising the principal senior executives, but indirectly by evaluating the performance of those executives and replacing any who are not meeting reasonable expectations concerning job performance.").

16. GUIDEBOOK, *supra* note 5, at 11.

17. ALI PRINCIPLES, *supra* note 5, § 3.02(a)(1).

18. *Custom Report for 11-1011-00—Chief Executives*, O\*NET ONLINE, <http://www.onetonline.org> (last visited Nov. 12, 2011) [hereinafter O\*Net Chief Executive Report] ("chief executives" include the

cal functions of the officers include entering into ordinary business transactions,<sup>19</sup> devising business strategies,<sup>20</sup> setting business goals,<sup>21</sup> managing risks,<sup>22</sup> and generally working with subordinates to “[p]lan, direct, or coordinate operational activities.”<sup>23</sup> Clearly, these management functions of the officers are very different from the director oversight functions.

## B. INFORMATION, TIME, AND COMPENSATION: REAL REFLECTIONS OF DIVERGENT RESPONSIBILITIES

Officers and directors are further distinguished by their very different time commitments to the business, level of access to corporate information, and compensation. These differences reflect the divergent roles played by directors and officers in corporate governance.

### 1. Time Commitment

While Mr. Graf is correct that current expectations for director engagement and preparation are far greater than in the recent past,<sup>24</sup> directors still spend only a small fraction of the amount of time that officers spend in fulfilling their respon-

“Chief Executive Officer (CEO), President, Chief Financial Officer (CFO), Vice President, Chief Operating Officer (COO), Executive Director, Executive Vice President (EVP), Finance Vice President, General Manager, Operations Vice President”). The Occupational Information Network (O\*Net) is developed under the sponsorship of the U.S. Department of Labor/Employment and Training Administration through a grant to the North Carolina Employment Security Commission, which operates the National Center for O\*Net Development. *About O\*Net*, O\*NET ONLINE, <http://www.onetcenter.org/overview.html> (last visited Nov. 12, 2011).

19. See MODEL BUS. CORP. ACT § 8.41 cmt., at 8-64.

20. For an illustration of officers devising major business strategies without the involvement of the board of directors, consider how after executives at Goldman Sachs realized that the company’s “\$6 billion bet on American home loans” was a potential disaster in the making, the chief financial officer and three subordinate executives developed a seven-point strategy for unloading the bad debt and making a hefty profit in the process. The executives turned Goldman’s \$6 billion long position into a \$10 billion short position without any involvement of the company’s board of directors. See Matt Taibbi, *The People vs. Goldman Sachs*, ROLLING STONE, May 26, 2011, at 41, 43 (citing U.S. SENATE PERMANENT SUBCOMM. ON INVESTIGATIONS, WALL STREET AND THE FINANCIAL CRISIS: ANATOMY OF A FINANCIAL COLLAPSE (Apr. 13, 2011), available at [http://hsgac.senate.gov/public/\\_files/Financial\\_Crisis/FinancialCrisisReport.pdf](http://hsgac.senate.gov/public/_files/Financial_Crisis/FinancialCrisisReport.pdf)).

21. For an example of officers setting goals, the executive committee at Countrywide set a goal to achieve 30 percent market share within a five-year time period. See Connie Bruck, *Angelo’s Ashes*, NEW YORKER, June 29, 2009, at 46, 50.

22. GUIDEBOOK, *supra* note 5, at 11.

23. O\*Net Chief Executive Report, *supra* note 18; see also Howard Berkes, *Questions Remain Year After W. Va. Mine Explosion*, NPR (Apr. 9, 2011), <http://www.npr.org/2011/04/09/135251710/questions-remain-year-after-w-va-mine-explosion> (for an example of an officer implementing corporate policy and working with subordinates to direct operational activities, see the memo (referenced in the article) from Don Blankenship, former President and CEO of Massey Energy, instructing his deep mine superintendents as follows: “If any of you have been asked by your group presidents, your supervisors, engineers or anyone else to do anything other than run coal (i.e.—build overcasts, do construction jobs, or whatever) you need to ignore them and run coal.” The article points out that “[b]uilding overcasts is a safety function designed to improve ventilation in mines.”).

24. Graf, *supra* note 1, at 325.

sibilities to the corporation.<sup>25</sup> Prior to the passage of the Sarbanes-Oxley Act in 2002, directors spent an average of fourteen hours per month on board matters.<sup>26</sup> That number jumped to nineteen hours in 2003,<sup>27</sup> and the figure has hovered at around twenty hours per month through at least 2009.<sup>28</sup> Even under a conservative estimate that officers spend fifty hours per week on the job,<sup>29</sup> that would be 200 hours per month, which means that officers spend around ten times the amount of time that directors spend in fulfilling their duties to the corporation.<sup>30</sup>

Serving as a director is “not a hobby,” but it is important to remember that most directors also hold demanding full-time jobs and serve on multiple boards of directors.<sup>31</sup> As an illustration, of the six non-management directors at Google, five hold top-level executive positions at other entities, and the sixth is a director at four other large companies.<sup>32</sup>

## 2. Compensation

Mr. Graf argues that non-management directors are “well compensated,” citing that “in 2009, non-management directors at General Electric Company (‘GE’) received average annual compensation of just over \$356,000; more than half of that average sum [in] incentive compensation.”<sup>33</sup> What Mr. Graf fails to mention

25. See *infra* notes 27–29.

26. See WHAT DIRECTORS THINK: CORP. BOARD MEMBER/PRICEWATERHOUSECOOPERS SURVEY 14 fig. 31 (2005 Special Supp.), available at [http://www.pwc.com/en\\_US/us/corporate-governance/assets/cbmdt-2005.pdf](http://www.pwc.com/en_US/us/corporate-governance/assets/cbmdt-2005.pdf).

27. *Id.*

28. See WHAT DIRECTORS THINK: CORP. BOARD MEMBER/PRICEWATERHOUSECOOPERS SURVEY 12 (2009 Special Supp.), available at <http://www.pwc.com/us/en/corporate-governance/assets/what-directors-think-2009-supplement.pdf>; see also STUDY GRP. ON CORPORATE BDS., BRIDGING BOARD GAPS: REPORT OF THE STUDY GROUP ON CORPORATE BOARDS 56 n.8 (2011), available at [http://weinbergcgg.typepad.com/files/final-studygroup\\_final\\_spreads.pdf](http://weinbergcgg.typepad.com/files/final-studygroup_final_spreads.pdf) [hereinafter BRIDGING BOARD GAPS] (citing 2010 NACD Corporate Governance Survey, finding that on average per year, directors spend 71.5 hours in meetings, 61.8 hours reviewing reports, 36.4 hours traveling to and from meetings, 20.1 hours receiving education, 8.6 hours representing the company (or board) at events, and 13.5 hours engaged in other activities related to board service. These averages are not cumulative, but add up to slightly more than 210 hours per year, so the 20-hour-per-month estimate from the What Directors Think survey may be high.).

29. We believe officers likely spend more than fifty hours per week on the job, but we use fifty hours as an estimate since empirical research on the matter is limited. However the O\*Net Chief Executive Report, *supra* note 18, reports that over 90 percent of officers work more than forty hours per week. For purposes of these findings, the officers include those with the titles listed in note 18.

30. See *supra* note 28 (directors spend twenty hours per month, about five hours per week, fulfilling their board duties). We think our estimates understate the differential but we are seeking to make a conservative comparison.

31. Graf, *supra* note 1, at 325; see also PRICEWATERHOUSECOOPERS, LLC, ANNUAL CORPORATE DIRECTORS SURVEY: THE 2010 RESULTS (2010), at 31–32, available at <http://www.pwc.com/us/en/corporate-governance/assets/annual-corporate-directors-survey-2010.pdf>.

32. GOOGLE, NOTICE OF 2011 ANNUAL MEETING AND PROXY STATEMENT 11–12 (2011), available at <http://investor.google.com/proxy.html> (follow “2011 Proxy Statement” hyperlink) [hereinafter GOOGLE PROXY STATEMENT]. The Google non-management directors include L. John Doerr, General Partner of Kleiner Perkins Caufield & Byers; John L. Hennessy, President of Stanford University; Ann Mather, a member of the boards of directors at Glu Mobile Inc., MBM Holdings Inc., MoneyGram International, and Netflix, Inc.; Paul S. Otellini, CEO and President of Intel Corporation; K. Ram Shriram, a managing partner of Sherpalo Ventures, LLC; and Shirley M. Tilghman, President of Princeton University.

33. Graf, *supra* note 1, at 333–34.

is that in 2010, the GE executive officers received average total compensation of about \$15.2 million each, or over fifty times the compensation of the directors.<sup>34</sup> This 50 to 1 ratio was generally consistent across the board for large public companies in 2010.<sup>35</sup>

Perhaps even more important in determining whether compensation provides similar incentives for directors and officers, consider that more than half of the directors at GE serve, or have served, as chief executives of Fortune 500 companies.<sup>36</sup> Put simply, serving on corporate boards is not how many directors earn their bread. Further to this point, consider that in 2010, average compensation for the GE named executive officers increased by 12.5 percent,<sup>37</sup> but average compensation for the non-management directors at GE dropped by 20 percent.<sup>38</sup>

### 3. Access to Information

Corporate officers are unquestionably better positioned to gain access to corporate information than members of the board of directors. Consider the access to company information enjoyed by the officers at Google. The key managers of Google's different business divisions meet in a conference room several afternoons each week to work as if in a "war room situation."<sup>39</sup> These officers discuss business strategies and raise different issues and ideas that may come up during a regular business day.<sup>40</sup> In contrast, the Google board of directors held seven meetings and

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34. GEN. ELEC. CO., NOTICE OF 2011 ANNUAL MEETING AND PROXY STATEMENT 30 (2011), available at <http://www.ge.com/ar2010/pdf/122802ACL.pdf> [hereinafter GE PROXY STATEMENT] (CEO and Chairman Jeffrey Immelt topped the list of GE named executive officers in 2010 with total compensation of \$21.4 million, while the other four named executive officers received total compensation of between \$12.8 and \$14.3 million.).

35. Average compensation for chief executives was nearly \$12 million in 2010, while median compensation for non-management directors was \$228,540. See *Pay Up: Overpaid Bosses Are Back*, ECONOMIST, June 18, 2011, at 74 (citing GovernanceMetrics International (GMI) for the information on chief executive compensation); see Lou Taormina, *2010 Director Compensation: NASDAQ 100 vs. NYSE 100*, FREDERIC W. COOK & CO., INC. 2 (Aug. 2010), [http://www.fwcook.com/alert\\_letters/2010\\_Director\\_Compensation\\_NASDAQ\\_100\\_vs\\_NYSE\\_100\\_Non-Employee\\_Director\\_Compensation\\_at\\_the\\_100\\_Largest\\_NASDAQ\\_and\\_100\\_Largest\\_New\\_York\\_Stock\\_Exchange\\_Companies.pdf](http://www.fwcook.com/alert_letters/2010_Director_Compensation_NASDAQ_100_vs_NYSE_100_Non-Employee_Director_Compensation_at_the_100_Largest_NASDAQ_and_100_Largest_New_York_Stock_Exchange_Companies.pdf) (finding that the median total value of director compensation increased from \$205,000 in 2009 to \$228,540 in 2010). Median compensation for chief financial officers at S&P 500 companies for 2010 was \$2.9 million, many times the median pay for non-executive directors. James Willhite, *Pay Tally Up 19% for Finance Chiefs*, WALL ST. J., June 30, 2011, at B1.

36. GE PROXY STATEMENT, *supra* note 34, at 11–16.

37. *Id.* at 30 (average total compensation for the named executive officers in 2009 was \$13.5 million).

38. *Id.* at 44; see also GEN. ELEC. CO., NOTICE OF 2010 ANNUAL MEETING AND PROXY STATEMENT 40 (2010), available at [http://www.ge.com/pdf/investors/financial\\_reporting/proxy\\_statements/ge\\_proxy\\_2010.pdf](http://www.ge.com/pdf/investors/financial_reporting/proxy_statements/ge_proxy_2010.pdf) (total compensation per GE director dropped from \$356,000 in 2009 to \$296,335 in 2010); see also *supra* note 35 (discussing the more than 11 percent increase in pay for non-management directors of large public companies in 2010).

39. *Life 'In The Plex': The Future of Google*, NPR (Apr. 4, 2011), <http://www.npr.org/templates/transcript/transcript.php?storyId=135023714> (transcript of National Public Radio Morning Edition with Renee Montagne, interviewing Steven Levy, author of *In the Plex: How Google Thinks, Works, and Shapes Our Lives*).

40. *Id.*



acted by written consent four times in 2010.<sup>41</sup> The Google officers likely spend more time together in a month than the directors spend together all year.

While conceding that directors are not in as frequent contact with corporate information, Mr. Graf counters that directors can “demand access to any information that they may deem necessary to fulfill their managing and monitoring duties.”<sup>42</sup> However, the ability to demand information cannot put the directors in the same position as officers. Any information provided to directors is either created by the officers or produced under the direction of the officers.<sup>43</sup> Further, directors often cannot dedicate the same amount of time as the officers to reviewing or following up on this information, and even if they did, officers have “firm-specific familiarity with the details of the particular companies they manage,” which makes the information much more meaningful to those officers.<sup>44</sup>

State corporate statutes recognize the informational gap between the officers and directors, and thus protect directors from personal liability for actions taken in reliance on information provided by officers.<sup>45</sup> Renowned Delaware lawyer R. Franklin Balotti and Megan W. Shaner argue that “[b]ecause directors are entitled to such protection, officers should arguably be held to a strict standard of care and requirement to be fully informed.”<sup>46</sup> This statutory treatment allowing directors to rely on information from the officers reflects that officers have much greater access to and understanding of corporate information, and also is a testament to the different roles and functions of the officers as compared to the directors.

### C. THE CENTRAL ROLE OF OFFICERS

Overlooking the stark differences noted above, Mr. Graf fails to acknowledge the reality that corporate officers, not directors, occupy the central role in corporate governance. Of the three main actors in corporate governance (shareholders, directors, and officers), the officers clearly continue to reign supreme.<sup>47</sup> Shareholders are more likely to sell their shares than try to effect corporate change,<sup>48</sup> while, distressingly, directors tend to consider the CEO to be the “boss.”<sup>49</sup>

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41. GOOGLE PROXY STATEMENT, *supra* note 32, at 14, 16–17. The Google Audit Committee also met six times, the Nominating and Corporate Governance Committee met five times, and the Leadership Development and Compensation Committee met five times. The Audit and Nominating and Corporate Governance Committees did not act by written consent during 2010, but the Leadership Development and Compensation Committee acted by written consent twenty-five times.

42. Graf, *supra* note 1, at 323.

43. “Boards only know what the CEO and CFO tell them. Nothing more.” BRIDGING BOARD GAPS, *supra* note 28, at 20 (quoting Richard Beattie, Chairman of Simpson, Thacher and Bartlett LLP).

44. See Johnson & Millon, *supra* note 4, at 1618.

45. Balotti & Shaner, *supra* note 9, at 172 & n.45 (citing DEL. CODE ANN. tit. 8, § 141(a); MODEL BUS. CORP. ACT § 8.30(d)–(f)).

46. *Id.* at 172.

47. See Megan Wischmeier Shaner, *Restoring the Balance of Power in Corporate Management: Enforcing an Officer's Duty of Obedience*, 66 BUS. LAW. 27, 51 (2010).

48. *Id.* at 51 n.153 (“Our vast and highly liquid financial markets enable large institutional shareholders to sell their shares when they perceive inadequacies of corporate governance, rather than

An illustration of this central role of the officer is found amidst the global furor prompted by the Gulf of Mexico oil spill. Following the spill, Tony Hayward, then chief executive of BP, was dubbed America's "most hated" and "clueless" man,<sup>50</sup> and was under such intense pressure from the media and general public that he was forced to resign.<sup>51</sup> The BP board members, by contrast, including the chairman Carl-Henric Svanberg, were spared such treatment and retained their board seats.

Similarly, consider how officers were at the heart of the economic scandals in the early 2000s and more recently with the global financial crisis.<sup>52</sup> Or consider how successful chief executives like Steve Jobs and Mark Zuckerberg are under the constant glare of the media spotlight. Officers, not directors, occupy center stage because officer performance is crucial to the success or failure of the companies these officers run and to the economy as a whole.<sup>53</sup>

Mr. Graf ignores this central role of the officer, going so far as to argue that enforcing officer fiduciary duties would be inappropriate because it would be difficult to define who the "officers" are for purposes of fiduciary duty liability.<sup>54</sup> Curiously, in two pages of discussion about how difficult it would be to define whether someone is an "officer,"<sup>55</sup> Mr. Graf fails to mention that Delaware's long-arm statute provides an explicit definition of the term for purposes of taking jurisdiction over such officers in the Delaware courts.<sup>56</sup> The Delaware General Corporation Law ("DGCL") and the Model Business Corporation Act ("MBCA") also provide

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fix them. This has placed de facto control in the hands of the chief executive officer." (quoting *Excerpts from Report by Greenspan at Senate*, N.Y. TIMES, July 17, 2002, at C8)).

49. *Id.* at 51 & n.154 (citing Johnson & Millon, *supra* note 4, at 1613–14). The widespread practice of the CEO also serving as chairperson of the board of directors enhances this problem because the most influential member of the board of directors is also the most senior officer that must be monitored.

50. Helen Kennedy, *BP's CEO Tony Hayward: The Most Hated—and Most Clueless—Man in America*, N.Y. DAILY NEWS "June 3, 2010," available at [http://articles.nydailynews.com/2010-06-03/news/27065997\\_1\\_bp-brand-lord-john-browne-british-oil](http://articles.nydailynews.com/2010-06-03/news/27065997_1_bp-brand-lord-john-browne-british-oil).

51. Rowena Mason, *BP's Tony Hayward Resigns After Being "Demonised and Vilified" in the US*, TELEGRAPH (July 27, 2010, 12:42 PM BST), <http://www.telegraph.co.uk/finance/newsbysector/energy/oilandgas/7912338/BPs-Tony-Hayward-resigns-after-being-demonised-and-vilified-in-the-US.html>.

52. See Shaner, *supra* note 47, at 28, 50; see also Johnson & Garvis, *supra* note 3, at 1105–06.

53. See Johnson & Millon, *supra* note 4, at 1599.

54. Graf, *supra* note 1, at 335 ("If Delaware courts decide to impose a form of officer liability, it is incumbent on the courts to specify precisely which officers are at risk for personal liability, and how they can be identified.")

55. *Id.* at 334–35.

56. See DEL. CODE ANN. tit. 10, § 3114(b) (2010) ("[T]he word 'officer' means an officer of the corporation who (i) is or was the president, chief executive officer, chief operating officer, chief financial officer, chief legal officer, controller, treasurer or chief accounting officer of the corporation at any time during the course of conduct alleged in the action or proceeding to be wrongful, (ii) is or was identified in the corporation's public filings with the United States Securities and Exchange Commission because such person is or was [one] of the most highly compensated executive officers of the corporation at any time during the course of conduct alleged in the action or proceeding to be wrongful, or (iii) has, by written agreement with the corporation, consented to be identified as an officer for purposes of this section."); see also *Gantler v. Stephens*, C.A. No. 2392-VCP, 2008 WL 401124, at \*7 (Del. Ch. Feb. 14, 2008). The Delaware Court of Chancery applied the long-arm statute's definition of "officer" in the *Gantler v. Stephens* line of cases.

that corporations may have such “officers” as are named in the bylaws or approved by the board of directors in accordance with those bylaws.<sup>57</sup> Clearly, holding one of these enumerated officer positions will subject an individual to personal jurisdiction in state courts. Determination of who is an “officer” in a particular public corporation should not be difficult, given this authoritative guidance.

### III. MODELING THE OFFICER’S ROLE: AGENCY THEORY AS REALITY

We believe that the divergent roles played by directors and officers in corporate governance should matter for fiduciary duty analysis. We believe too that agency law principles serve to illuminate further the differences while also supplying the default rules for officer duties.

Mr. Graf concedes, as he must, that corporate officers are agents of the corporation.<sup>58</sup> But he considers their agency status to be “an unpersuasive technicality,”<sup>59</sup> and he believes that officers should not be treated “exactly like other agents.”<sup>60</sup> The agency status of corporate officers in law is clear,<sup>61</sup> just as it is equally clear that corporate directors typically are not agents.<sup>62</sup> As stated by the Delaware Supreme Court in *Arnold v. Society for Savings Bancorp, Inc.*<sup>63</sup>:

Directors, in the ordinary course of their service as directors, do not act as agents of the corporation. . . . It would be an analytical anomaly, therefore, to treat corporate directors as *agents* of the corporation when they are acting as *fiduciaries* of the stockholders in managing the business and affairs of the corporation.<sup>64</sup>

Directors, in other words, oversee the interests of the corporation, an organization that is a legal but artificial entity unable by itself to advance and protect its own interests. Acting on behalf of the corporations they serve<sup>65</sup>—not their own behalf—directors do for those companies exactly what many individual persons do: employ agents. Chief among those persons so engaged by a corporation are executive officers. When they act for the corporation, such officers clearly are agents of the corporate principal, deployed as such by the directors, who themselves represent the inanimate corporation’s interests. In this way, we see yet again the quite different functions and corresponding legal statuses of

57. See DEL. CODE ANN. tit. 8, § 142(a) (2001); MODEL BUS. CORP. ACT § 8.40(a) (2011).

58. Graf, *supra* note 1, at 326 (“Officers are agents.”).

59. *Id.* at 317, 327.

60. *Id.* at 326.

61. See, e.g., Johnson & Millon, *supra* note 4, at 1605–06 & n.27.

62. *Id.* at 1605 & n.25, 1620.

63. 678 A.2d 533 (Del. 1996).

64. *Id.* at 539–40.

65. Graf believes this straightforward arrangement, standard in business organizations, presents a “theoretical quagmire.” Graf, *supra* note 1, at 327. Keeping in mind that, under modern corporate statutes and business necessity, directors of public companies oversee but do not manage the business and affairs of the corporation, the relationship of directors and officers, in practice and theory, is quite clear. Directors act on behalf of the company (the principal) to hire officers who become managing agents of the company, not agents of the directors. See Johnson & Millon, *supra* note 4, at 1648–49. Equating directors and officers as “managers” muddies the governance relationship.

directors and officers in corporate governance. Directors are not, but officers are, agents.

Agency law therefore provides a pre-existing set of expectations and principles that, unlike the case with directors, does not require “starting from scratch” in modeling the officer’s role in corporate governance. Moreover, an agency relationship is inherently fiduciary in character and it is consensual, but contrary to Mr. Graf’s assertion,<sup>66</sup> it can arise independently of contract.<sup>67</sup> Given the agency status of executive officers, the key question is whether a core feature of agency law—fiduciary duties—also will be adopted by corporate law or, instead, will be modified in some fashion to achieve particular policy goals. We make several brief points here in this regard and refer the reader to other scholarship for fuller treatment.<sup>68</sup>

First, since executive officers undoubtedly are agents, the default and baseline standard for the fiduciary duties they owe should be drawn from agency law,<sup>69</sup> the body of law traditionally governing that subject. Those who find this objectionable, for whatever reason, must make a compelling case as to why these standard default rules, including the generally applicable standard of “normal” or ordinary care,<sup>70</sup> do not apply to officers. Of course, a key element of making such a case is to state convincingly why the quite different functions of officers and directors in corporate governance—sketched in Part II above—are of no significance on the fiduciary duty issue. We think it is incumbent on Mr. Graf and others to demonstrate persuasively why, when it comes to default fiduciary duties, officers uniquely are *not* “exactly like other agents.”<sup>71</sup>

Second, there is no obvious reason why an organizational principal, such as a corporation, should expect or be entitled to a lower standard of care (or other duties) from its agents than that expected by individual principals, whose expectations clearly are provided by the precepts of agency law.<sup>72</sup> If anything, the monitoring of agents by an organizational principal is more challenging than monitoring by an individual principal and, on that ground, a stricter not looser standard should be owed. Third, doubts about equating directors and officers for personal liability purposes have long existed in Delaware, dating back at least to the legislative decision not to include officers within the exculpation coverage of section

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66. Graf, *supra* note 1, at 328 (“agency is a contractual relationship”).

67. DANIEL S. KLEINBERGER, *AGENCY, PARTNERSHIPS, AND LLCs: EXAMPLES AND EXPLANATIONS* 117 n.2 (2d ed. 2002) (stating “an agent typically owes duties in contract as well as under agency law”); *see also* GAB Bus. Servs., Inc. v. Lindsey & Newsom Claim Servs., Inc., 99 Cal. Rptr. 2d 665, 670 (Ct. App. 2000) (noting that fiduciary duties of officers arise independently of contract).

68. *See generally* Johnson & Millon, *supra* note 4; *see also* Lyman Johnson, *Having the Fiduciary Duty Talk: Model Advice for Corporate Officers (and Other Senior Agents)*, 63 *BUS. LAW.* 147, 148–52 (2007).

69. RESTATEMENT (THIRD) OF AGENCY §§ 8.01–8.12 (2006).

70. *Id.* § 8.08 (“Subject to any agreement with the principal, an agent has 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. If an agent claims to possess special skills or knowledge, the agent has a duty to the principal to act with the care, competence, and diligence normally exercised by agents with such skills or knowledge.”).

71. Graf, *supra* note 1, at 326.

72. *See supra* note 68 and accompanying text.

102(b)(7), as was done for directors.<sup>73</sup> This reflects an acknowledged difference between the responsibilities of officers and directors that has endured for twenty-five years. Although in 2009 the Delaware Supreme Court equated director and officer duties in general terms,<sup>74</sup> it did not resolve a host of other issues pertaining to corporate officers, including the precise standard of care for officers.<sup>75</sup>

Finally, as the corporate law community grapples with the emerging law of corporate officers, we should be careful not to apply automatically concerns about overly strict director liability standards to officers. The modern director care standard has settled at the gross negligence level,<sup>76</sup> and in Delaware directors can be exculpated from personal liability for breaching the duty of care.<sup>77</sup> These movements toward greater personal protection for directors were grounded in real, if still debatable, concerns about a rash of costly litigation and a perceived unwillingness of many persons to serve on corporate boards or take appropriate business risks without enhanced immunity. But do these concerns demonstrably apply to officers? Will we see an upsurge in litigation against officers, an unwillingness to occupy the executive suite, and other adverse effects if officers are held to the customary standard of care for all other agents, which is only somewhat stricter than that for directors? The next part argues that such an outcome is highly unlikely.

#### IV. DIRECTORS, NOT COURTS, ADDRESS MOST OFFICER WRONGDOING; UNLIKELY ADVERSE EFFECTS OF OFFICER ACCOUNTABILITY

Corporate directors, owing fiduciary duties of care and loyalty, face the prospect of being sued by shareholders, either directly or derivatively, for breaching their duties.<sup>78</sup> Of course, to initiate a derivative suit on behalf of the corporation itself, shareholders must plead that a demand on the board to begin litigation would

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73. DEL. CODE ANN. tit. 8, § 102(b)(7) (2001 & Supp. 2010). Another difference in Delaware is the statutory right of directors to rely on others. See *supra* notes 45–46 and accompanying text.

74. See *Gantler v. Stephens*, 965 A.2d 695, 708–09 (Del. 2009).

75. Johnson & Garvis, *supra* note 3, at 1108. Professor Johnson and Dennis Garvis, writing in 2009, described the open issues after *Gantler* as follows:

[W]hether and how the business judgment rule applies to officers in Delaware remains unclear. Moreover, the court in *Gantler* addressed the duty of loyalty issue, not the duty of care issue. Also, the case did not involve officer oversight responsibilities. Thus, we continue to lack clear guidance as to the scope and reach of officer duties of care and good faith. Relatedly, the Delaware Supreme Court also did not address the ordinary negligence versus gross negligence standard in the care context, as the issue was not before it. Finally, given rather significant differences in the roles and responsibilities of directors and officers within corporate governance, the court did not explain the reason for equating their fiduciary duties. Clearly the area of officer duties remains murkier than that of director duties.

*Id.*

76. See *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984).

77. See *supra* note 73 (Delaware's director exculpation statute).

78. *Tooley v. Donaldson, Lufkin & Jenrette, Inc.*, 845 A.2d 1031, 1033 (Del. 2004) (“Whether a stockholder’s claim is derivative or direct . . . must turn *solely* on the following questions: (1) who suffered the alleged harm (the corporation or the suing stockholders, individually); and (2) who would receive the benefit of any recovery or other remedy (the corporation or the stockholders, individually)?”).

be futile.<sup>79</sup> Even if a derivative claim is rightly commenced without a pre-suit demand, a properly functioning special committee can move to dismiss the claim if the committee believes doing so is in the best interests of the corporation.<sup>80</sup> At the root of the law and practice of derivative litigation is the recognition that the claim is an asset of the corporation itself and, therefore, it is presumptively subject to control by the board or a board committee.

With respect to claims of wrongdoing by officers this is even more obviously the case. If officers are conceived of as agents of the corporation, their misconduct wrongs the company and creates a legal claim belonging to the corporation, just as, conversely, their conduct as agents toward third parties can create liability for the corporation.<sup>81</sup> Even those persons who reject an agency conception of officers, however, would have to agree that officer conduct damaging to the company itself creates a corporate derivative claim, not a direct claim.<sup>82</sup> Thus, indisputably, the board of directors, not stockholders, would be the appropriate body for addressing such claims. The exception would be those claims that are pursued in bankruptcy court where the trustee in bankruptcy would exercise control over claims against officers, but even those actions would be assets of the corporate estate.

With boards of directors controlling most claims against officers, we think there will be relatively few lawsuits initiated by directors against officers. We expect that most officer misconduct coming to the attention of the board will be resolved as part of an intra-corporate sanction, whether that sanction be discharge, reprimand, compensation adjustment, demotion, or delayed promotion.<sup>83</sup> Those officers who leave employment frequently receive severance payments,<sup>84</sup> and those exit packages likely also entail the mutual release of all claims. Directors, more-

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79. *Aronson*, 473 A.2d at 818.

80. *Zapata Corp. v. Maldonado*, 430 A.2d 779, 785–86, 788 (Del. 1981).

81. Under a variety of theories—e.g., actual or apparent authority—a corporation can be held legally responsible for an officer's actions. RESTATEMENT (THIRD) OF AGENCY §§ 2.01–2.04 (2006).

82. We do not rule out the possibility that certain kinds of claims against officers might be characterized as direct claims. Briefly, we make a few points on a subject that warrants more attention. First, claims against an executive who also serves on the board of directors must differentiate wrongdoing as an officer from wrongdoing in director capacity. Second, direct claims against officers are most likely to arise in significant transactions such as mergers and acquisitions where a senior officer is attending, by delegation, to what is ultimately a board-level function that bears directly on a shareholder's interest as a shareholder. Third, permitting direct suits against officers is not inconsistent with an agency theory of officers. Rather, such claims involve those actions by officers, acting on behalf of corporations, which directly bear on the interest of a shareholder as a shareholder. Of course, both direct and derivative claims can arise from a single transaction. *Grimes v. Donald*, 673 A.2d 1207 (Del. 1996). With respect to public corporations at least, we expect that the vast majority of claims against officers will be derivative in nature.

83. For some reason, Graf states that Professor Johnson “bypasses the reality that officers face immediate expulsion by the board for reckless conduct.” Graf, *supra* note 1, at 333. Yet Graf's own footnote 99 quotes from scholarship by Professor Johnson that recognizes that the board may pursue “an intra-firm sanction.” *Id.* at 337 n.99. Moreover, Johnson and Mark Sides, writing in 2004, stated that “boards may negotiate settlements with officers as part of an intra-corporate sanction, whether that be discharge, reprimand, compensation adjustment, demotion, or delayed promotion.” Lyman P.Q. Johnson & Mark A. Sides, *The Sarbanes-Oxley Act and Fiduciary Duties*, 30 WM. MITCHELL L. REV. 1149, 1207–08 (2004); see also Johnson & Millon, *supra* note 4, at 1611.

84. Johnson & Millon, *supra* note 4, at 1611 n.57 (describing Conference Board study that 62 percent of executives who left because of major violations of ethics and compliance codes received

over, are in a position to negotiate a tougher exit arrangement if they invoke officer breaches of duty as leverage in departure discussions. Such breaches of duty, of course, operate independently of employment contracts. Too often, directors and their counsel may narrowly focus only on the terms of an officer's employment agreement, forgetting that fiduciary duties transcend such agreements. Whether used as a negotiating lever or not, fiduciary duty claims against executives likely are "settled up" at the departure stage and therefore will not be litigated. This probably reflects the pattern followed by most disappointed principals, the majority of whom likely discharge, rather than sue, wrongdoing agents. Consequently, judges will rarely have to make the determination as to whether an officer did or did not behave negligently. And in those infrequent cases that are pressed, judges will understand that the directors (or bankruptcy trustee) believe these cases to be of special importance to the corporation's best interests.

Appreciating the institutional reality of how (and where) most claims against corporate officers will be handled helps us see that the examples posed by Mr. Graf on the top of page 322 of his article are not as difficult to resolve as he believes.<sup>85</sup> We think that all of Mr. Graf's examples do reveal inexcusable carelessness, especially the third and fourth instances. One should not be "unduly swayed" in introducing a new product when "additional research" would reveal flaws, and "neglecting" a criminal background check when hiring for a position of trust is unacceptably careless. But people in organizations face those and countless other situations and challenges every day, and many of us make mistakes. Mistakes rarely lead to discharge, however, or even to other lesser sanctions. This is not because officers should be under any illusion, as Mr. Graf contends,<sup>86</sup> that they do not face monetary damages for negligence, but for at least three other reasons.

First, it is inefficient for any principal to try to detect/prevent all carelessness or wrongdoing and to pursue legal claims for all such behavior. Much behavior that is below standard simply and sensibly goes by the board, either because it is

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a financial package). Increasingly, executives negotiate severance agreements long before actual departure. A recent study found that in 2007 more than 55 percent of S&P 500 firms had awarded top executives severance contracts as part of their overall compensation package. Peggy Huang, *Marital Prenups? A Look at CEO Severance Agreements* 1 (Mar. 15, 2011), <http://ssrn.com/abstract=1786540> (follow "One-Click Download" hyperlink). The study found that the median CEO severance payment averaged about \$7 million. *Id.* Professor Huang also found that firms with such severance arrangements experienced significant underperformance in their future stock returns. *Id.* at 4. Use of cash rather than equity as the form of payment worsened the performance. *Id.* For purposes of our work, Professor Huang further found that cash payment severance contracts induce CEOs to take excess risks—the payments essentially representing "put" options—while equity element severance contracts significantly lessen excess risk-taking behavior. *Id.* at 5. The point is that executive compensation appears to influence executive behavior, from a risk standpoint.

85. See Graf, *supra* note 1, at 322.

86. *Id.* ("Officers believe the maximum penalty for neglectful conduct in fulfilling job responsibilities is disciplinary action or expulsion, not monetary damages."). This lack of knowledge on the part of officers—if true—is one reason why legal counsel should regularly advise officers of their fiduciary duties. See Johnson, *supra* note 68, at 152–56 (offering succinct model advice designed for this purpose). Limited empirical work suggests that both inside and outside legal counsel do not routinely advise officers about their duties. Johnson & Ricca, *supra* note 3, at 669–78; Johnson & Garvis, *supra* note 3, at 1119–20.

undetected or because it is deliberately left unsanctioned. Second, the standard is reasonable conduct, not perfect conduct, even under a negligence standard. Mr. Graf repeatedly and wrongly sets up a straw man in stating that officers should not have to have “all” information before they act<sup>87</sup>—no one says they do. They, like directors,<sup>88</sup> need only have the information that is “reasonably available,” although as noted in Part II, it is reasonable to expect that officers will have access to more information than directors. Both boards and courts should take account of imperfect information, time pressures, the significance of a matter, and a range of factors pertinent to the particular circumstances faced by the officer in a specific position. A review of the pertinent legal standard for agents reveals, not surprisingly, that an agent is expected to act only with the care, competence, and diligence “normally exercised” by similar agents in “similar circumstances.”<sup>89</sup> This, as always with fiduciary duty analysis, is a context and position-sensitive measure. An officer therefore will be held only to the normal “community” standard for such an officer. Moreover, the range of relevant considerations for officers, being more complex than for directors, who act only episodically, likely will lead to a fair bit of running room for officers under such a “normally exercised” standard. It is true, as Mr. Graf rightly contends,<sup>90</sup> that making negligence determinations can be challenging for a court, but by no means is that unique to the corporate setting. Nor is it a reason to give officers a lifetime free pass for such behavior, unlike other agents or negligent wrongdoers.

Third, as to the substance or merits of the business decision made, the substantive protection of the business judgment rule should be fully available to officers.<sup>91</sup> We merely (but importantly) contend that the duty of care for officers should be the ordinary and “normally exercised” care standard, not the looser gross negligence standard applicable to directors. We have not ever argued for depriving officers of the substantive protections of the business judgment rule for an officer’s business decisions, only that the rule’s protection should not sweep as broadly for officers as for directors on the duty of care aspect.

We recognize that, although officers are agents, their position and centrality in corporate governance distinguishes them from other agents in certain ways that, if anything, should reinforce deference to their substantive judgments. First, given their vast discretion and the very broad delegation of power from the board, executive officers infrequently are constrained by the “duty of obedience” that may more typically rein in an agent operating under closer supervision by a principal.<sup>92</sup> Lawyers and real estate agents, for example, however much professional latitude they have as to *how* they perform, typically have a client providing instructions as to *what* should be accomplished. Second, and relatedly, the board of directors

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87. Graf, *supra* note 1, at 323 (“all of the relevant information”), 329 (“all information”).

88. See *Paramount Commc’ns, Inc. v. QVC Network, Inc.*, 637 A.2d 34, 48 (Del. 1994).

89. See *supra* note 70.

90. Graf, *supra* note 1, at 328.

91. Lyman P.Q. Johnson, *Corporate Officers and the Business Judgment Rule*, 60 *BUS. LAW.* 439, 452 (2005).

92. RESTATEMENT (THIRD) OF AGENCY § 8.09 (2006) (duty to “comply with all lawful instructions”).



acting for the company, unlike other principals, typically communicates corporate goals in a very broad manner, perhaps expressing them in such metrics as profitability, market share, and growth. What course of action or strategies to be taken to achieve those goals is largely up to senior management, however. This means discretion over the substance of business decisions lies primarily with the agent, not the principal. There is little basis for holding someone liable for a substantive decision that deliberately was left to them to make in the first place. Third, executive officers operate in all industries. Unlike agents operating in particular industries, again such as lawyers (whatever their field) and real estate agents, where norms as to particular advisable substantive actions may develop, it would seem extraordinarily difficult, and contrary to the dynamic nature of business, to expect the same for managers. Consequently, the duty of care for officers must essentially be a process-oriented duty, though we emphasize again that the standard of “normally exercised” care means that courts can be expected to look to prevailing practices for guidance.

We also think that two additional points should be made as to possible effects of a stricter liability standard for officers than directors. First, Mr. Graf speculates that holding officers to the conventional agency standard of care would lead them to engage in a variety of dysfunctional behavior.<sup>93</sup> He conjectures that officers would seek to deflect responsibility, engage in scapegoating, and play it safe.<sup>94</sup> Whether this is true or not ultimately is an empirical question. We continue to think, however, that those concerns are implausible and a bit far-fetched. Officers do not climb the corporate ladder in a healthy business by engaging in such behavior. Successful executive officers, moreover, tend to be confident, determined, creative risk-takers who likely would not “play it safe,” if only because that conduct leads to obscurity and fewer rewards such as higher pay, promotion, and career mobility. And being careful, we emphasize, is not the same as not taking business risks. One can follow a sensible decision-making approach prior to undertaking ventures that carry quite significant business risk. Furthermore, by Mr. Graf’s own reckoning,<sup>95</sup> liability concerns are not demonstrable motivators in the executive suite. If anything, perhaps a bit more executive concern and lawyerly advice about liability would curb improper conduct.<sup>96</sup> Our legal system’s typical response to unacceptable behavior is to clamp down on it, not contend that the very effort of doing so might lead to post hoc finger-pointing by wrongdoers. The extent of scapegoating after the fact of wrongdoing, moreover, would seem to have little relationship to the standard of conduct applicable to a wrongdoer; intentional and reckless actors can likely “scapegoat” as well as others. And if dysfunctional behavior were repeatedly engaged in, as Mr. Graf fears, the officer’s superior officer, or the board itself, should act. This is precisely where high-functioning directors are so essential. They likely would not long tolerate

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93. Graf, *supra* note 1, at 321, 336.

94. *Id.*

95. See *supra* note 86 and accompanying text.

96. See *supra* note 86.

recurrent scapegoating or any other conduct not geared toward innovative business growth and profit enhancement; conduct inimical to attaining those goals likely would be ordered to stop or the officer rightly threatened with discharge.

Second, Mr. Graf contends that holding officers to the customary agency standard of care would result in “uninsulated exposure to unlimited liability.”<sup>97</sup> We doubt this as well. As noted above, we believe relatively few cases would even go to litigation. Moreover, all other agents in this country operate under such a standard and we do not observe a widespread outcry over agency law’s longstanding adoption of “unlimited” liability. And officers, where appropriate, would enjoy the usual protections of indemnification, advancement of expenses, D&O insurance, and, possibly, negotiated modifications of the care standard, about which we say more below. But it is important to corporate law and society that officers face—and know *ex ante* that they face—the prospect of judgment and the accountability and shame that accompanies significant misuse of power, even if monetary liability is reimbursed in some way.

In short, we are highly doubtful that a stricter (but conventional) standard of care for full-time officers than for part-time directors will lead to very much litigation, widespread liability, or dysfunctional conduct by officers. It may, however, serve a useful *ex ante* function if it is properly communicated.

## V. THE EX ANTE ROLE OF FIDUCIARY DUTIES

Recent empirical work suggests that lawyers do a better job of advising directors about fiduciary duties than in advising officers.<sup>98</sup> Certainly the usual focus on fiduciary duties is to emphasize their role as an *ex post* sanctioning and risk allocation device in litigation. This aspect receives the most attention and commentary, though an officer-specific focus is sorely lacking in traditional corporate law materials. We know far less about the role of fiduciary duties in shaping or altering director or officer conduct beforehand. It might be very informative to study both directors and senior management to learn what they actually know about fiduciary duties—as opposed to what lawyers say they tell their clients—and, somewhat more challenging, to determine how their understanding does or does not factor into their decision making.

We have developed elsewhere the reasons why providing an *a priori* understanding of fiduciary duties by officers is advisable.<sup>99</sup> Among these reasons are to inform officers that their behavior must adhere to legal standards separate and apart from what is set forth in their employment agreements, and that failure to adhere to those standards can result in sanctions, whether imposed in court or via the intra-corporate sanctions noted earlier.<sup>100</sup> Here, it suffices to say, in response to Mr. Graf, that fiduciary duties are not simply liability *rules* to be invoked *ex post*

97. Graf, *supra* note 1, at 321.

98. See Johnson & Ricca, *supra* note 3, at 670–74; Johnson & Garvis, *supra* note 3, at 1112–17.

99. Johnson & Ricca, *supra* note 3, at 665, 668, 678–92.

100. See *supra* Part IV.

in litigation. The duties of care and loyalty are affirmative, overarching *standards*, broadly phrased as such to serve the salutary purpose of reminding executive officers that in all their endeavors the primary focus is not to be their own self-interest or goals, but the best interests of the company. This may or may not alter behavior—empirically, we do not know—but it seems hard to believe that companies and their stockholders would be worse off if senior managers were regularly reminded by counsel that they should comply with the legal and social norms of loyalty and care and competence, which is what, reduced to their essence, such duties demand.

## VI. MISUNDERSTANDING CURRENT DUTIES

Much of Mr. Graf's article reads less like an argument against meaningful officer liability than a larger rejection of serious judicial review of fiduciary misconduct more generally. Moreover, Mr. Graf seems rather fundamentally to misunderstand what role the duty of care plays in corporate law, and he seeks to radically alter established analysis of that duty.

Current decisional law in Delaware is clear that, for directors at least, the duty of "care in the decision-making context is *process* due care only."<sup>101</sup> There is no "substance" to a court's review of due care.<sup>102</sup> Mr. Graf would jettison this bedrock tenet, stating: "Judicial restraint in reviewing substantive decisions should apply equally to process decisions as to substantive decisions."<sup>103</sup> And: "Judges should limit the scope of their review of corporate decision making, whether of the ultimate decision or the process used to arrive at that decision."<sup>104</sup> The reason for doing so, according to Mr. Graf, is that all judicial review suffers from hindsight bias and "rationality is in the eye of the beholder."<sup>105</sup> He posits, without support, that the line between process failures and substantive business decisions makes only theoretical, not practical, sense.<sup>106</sup> In place of existing duty of care doctrine, he believes that only reckless or intentional misconduct should be actionable, and then, based on the duty of loyalty.<sup>107</sup> And, in the name of "clarity," "the duty of care should be subsumed under the duty of loyalty."<sup>108</sup>

Briefly, we make several points about these ill-advised suggestions for doctrinal change. First, as noted above, most wrongdoing by officers will be handled internally by the board, whether rooted in a care or loyalty breach. Judges will make relatively few rulings on officers but these rulings are essential to exposit the law and, occasionally at least, expose to public scrutiny (and judicial comment) egregious misbehavior. Second, for liability purposes the gross negligence standard for

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101. *Brehm v. Eisner*, 746 A.2d 244, 264 (Del. 2000).

102. *Id.*

103. Graf, *supra* note 1, at 336.

104. *Id.* at 337.

105. *Id.*

106. *Id.* at 329.

107. *Id.* at 336.

108. *Id.* at 337.

directors already has been interpreted, in essence, as reckless indifference.<sup>109</sup> The duty of care for directors gives wide berth but it remains analytically distinct from the duty of loyalty. Third, the duty of care for both directors and officers remains meaningful for injunctive relief purposes, and should remain so by not watering it down further. Fourth, as a standard of conduct the duty of care is not merely an ex post liability rule; it is also designed to have an ex ante effect on deterring misconduct and guiding behavior for directors and officers. To eviscerate it is to remove this salutary benefit. Fifth, the process/substance distinction is foundational to judicial review of care. It represents the basic firebreak between a fiduciary duty—i.e., care—and the business judgment doctrine—i.e., that courts do not, in the care setting at least, make substantive business decisions. Attention to process is something courts are institutionally equipped to address, unlike second-guessing substantive business judgments. Moreover, emphasizing sound process in corporate decision making is grounded in the widespread belief in our legal system (think due process here) that we are more likely to get better substantive outcomes if the appropriate decision maker is accountable for *how* it makes a decision even if it is not accountable for *what* the decision is. Surely, flipping a coin is no way to decide whether or not to pursue a merger, for example, or whether a criminal defendant should be jailed, even if in retrospect the “right” decision was made. Mr. Graf would scrap that rationale in his quite radical proposal to expunge the duty of care from corporate law, even though it is already somewhat frail for directors.

Our position, specifically for officers, would seek to preserve the key process/substance distinction in the judicial review of due care. Courts should not second-guess substantive business judgments of officers but they should—in what we believe will be those relatively rare cases reaching courts—examine process, bearing in mind the overall context in which a decision was made. Moreover, officers, like all agents, should be expected to act reasonably, not better and not worse. This seems to us especially important at a time of widespread disenchantment with the behavior of many corporate executives, both within and outside the corporate world. The simple aim is to preserve the ex ante power of due care to shape conduct and the ex post capacity to sanction misconduct. In addition, although we believe the default standard of care for officers is now and should remain ordinary, “normally exercised” care, we believe too that corporations, via their boards, should be able to alter that standard by contract in specific cases. We would permit relaxing the standard to a gross negligence standard but no further,<sup>110</sup> recognizing we have little guidance as to whether, or how far, courts will permit contractual modification of officer duties. We believe as well that this should not be done categorically for all officers in the certificate of incorporation or bylaws, but only on

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109. *McPadden v. Sidhu*, 964 A.2d 1262, 1274 (Del. Ch. 2008) (“Delaware’s current understanding of gross negligence is conduct that constitutes reckless indifference or actions that are without the bounds of reason.”).

110. The *Restatement (Third) of Agency* states that a “contract may . . . , in appropriate circumstances, raise or lower the standard” applicable to the duties of care, competence, and diligence, but the *Restatement* does not indicate whether those duties can be eliminated altogether. *RESTATEMENT (THIRD) OF AGENCY* § 8.08 cmt. b (2006). Contracting around fiduciary duties for officers certainly

a case-by-case basis in individual employment agreements. This would permit a contractual relaxation to the default standard of care now applicable to directors,<sup>111</sup> while retaining for officers a somewhat stricter default rule. We do not believe Delaware courts would sustain contractual restrictions on monetary liability, in light of the General Assembly's decision in section 102(b)(7) to permit exculpation only for directors.<sup>112</sup>

A final point about the relationship between the fiduciary duties of directors and officers—and judicial review of those duties—is one that is often overlooked. Currently, the duty of loyalty for directors seems quite close to, if not identical with, the duty of loyalty owed by agents.<sup>113</sup> This outcome evolved haltingly, after a period of time when classic self-dealing transactions by directors potentially were avoidable.<sup>114</sup> Now, the duty of loyalty in corporate law takes director conflicts quite seriously, as does agency law, which seems to have influenced the law of director loyalty. Consequently, it is on the care front that director duties deviate from those of agency law. Bearing this in mind, the issue is not whether, generally, the fiduciary duties of directors and officers are or should be the same. In the loyalty area, they probably are the same and they are, essentially, the same as those of agents, even though directors are not agents. The issue, rather, is the narrower one of whether the duty of care for officers, who are agents, should similarly remain that applicable to agents generally or whether a convincing case can be made that, as with directors, only a looser standard of care should be demanded of officers. We should be clear, in other words, that the question of equivalent or divergent fiduciary standards for officers and directors is a live issue only with respect to the duty of care, although there are several dimensions to that issue.<sup>115</sup>

## VII. LAW MUST ADDRESS OFFICER CONDUCT; DELAWARE AND/OR THE FEDS?

Delaware law on corporate officers remains surprisingly undeveloped. It is true, as noted in Part IV, that it is to be expected that there will be fewer cases

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"invites a question as to the propriety of one fiduciary, the board of directors, relaxing the obligations of another fiduciary, senior officers." Johnson & Millon, *supra* note 4, at 1641; see also Aaron D. Jones, *Corporate Officer Wrongdoing and the Fiduciary Duties of Corporate Officers Under Delaware Law*, 44 *AM. BUS. L.J.* 475, 484–518 (2007). Jones cites positive law limits on director discretion in negotiating officer employment agreements and present case law to conclude that directors may be prohibited from agreeing to limit the fiduciary duty obligations of an officer beyond the standards of liability for a director. Jones also concludes that any such exculpatory agreements with an officer cannot condone any payments or limitation of liability for bad faith misconduct by the officer.

111. *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984).

112. See *supra* note 73.

113. See RESTATEMENT (THIRD) OF AGENCY §§ 8.01–8.06 (2006) (specifying aspects of the duty of loyalty). Delaware law similarly prohibits directors from improper self-dealing, wrongly usurping corporate opportunities, and improperly using confidential information. See *Broz v. Cellular Info. Sys., Inc.*, 673 A.2d 148, 154–55 (Del. 1996) (corporate opportunity doctrine); *Marciano v. Nakash*, 535 A.2d 400, 404 (Del. 1987) (self-dealing); *Hollinger Int'l, Inc. v. Black*, 844 A.2d 1022, 1061–62 (Del. Ch. 2004), *aff'd*, 872 A.2d 559 (Del. 2005) (confidential information).

114. *Marciano*, 535 A.2d at 404.

115. See *supra* note 75.

brought (and adjudicated) against officers than against directors. But the lower number of cases does not itself explain why the law of officer fiduciary duties has not been, in those cases that were brought, articulated more fully. *Gantler* was decided only two years ago, and it left open several important issues.<sup>116</sup> With its jurisdiction statute now reaching officers,<sup>117</sup> it appears that Delaware judges are inviting the bar to help them address and resolve these open questions.<sup>118</sup> Although we expect there will continue to be far fewer reported cases involving officers than directors due to intra-corporate resolutions for the former, judicial articulation of the law still matters, both for the cases that do proceed (in and out of Delaware courts) and to permit counsel to advise officers about legal standards concerning their conduct *ex ante*. Consequently, this is an opportunity for Delaware to write law on a less cluttered, if not blank, legal slate.<sup>119</sup> This is why, although we quite pointedly disagree with him, we welcome Mr. Graf's voice to the state law conversation. Judges, lawyers (litigators and planners), and corporate law scholars should continue to enrich this discussion. Corporate officers are too central to corporate governance to simply unthinkingly "default" their duties to those of corporate directors, as opposed to developing more affirmative bases for why officer duties should be the same as or, as we believe, different from, those of directors.

In the meantime, the non-criminal sanctioning of officers may be taking place in federal bankruptcy courts with respect to fiduciary duties and, more generally, by the SEC. The SEC has a broad arsenal of sanctions it can bring to bear against officer misconduct, including civil monetary penalties,<sup>120</sup> cease and desist

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116. *See id.*

117. Delaware's statute did not give the Delaware Court of Chancery personal jurisdiction over officers until January 1, 2004. DEL. CODE ANN. tit. 10, § 3114(b) (1999 & Supp. 2010) ("Every non-resident of this State who after January 1, 2004 accepts election or appointment as an officer . . .").

118. *See, e.g., In re Walt Disney Co. Derivative Litig.*, 907 A.2d 693, 777 n.588 (Del. Ch. 2005) ("The parties essentially treat both officers and directors as comparable fiduciaries, that is, subject to the same fiduciary duties and standards of review. Thus, for purposes of this case, theories of liability against corporate directors apply equally to corporate officers, making further distinctions unnecessary."); *Hampshire Grp., Ltd. v. Kuttner*, C.A. No. 3607-VCS, 2010 WL 2739995, at \*11 (Del. Ch. July 12, 2010) ("Generally, like directors, [officers] Clayton and Clark were expected . . . to use the amount of care a reasonably prudent person would use in similar circumstances (i.e., to fulfill their duty of care).").

119. This will also present an opportunity to revisit the awkward business judgment rule framework that began in the early 1990s in the *Cede* litigation. *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 361 (Del. 1993). There, the Delaware Supreme Court held that a breach of the duty of care for directors leads not to liability but to a shift of the burden of proof such that directors must prove entire fairness. There is no reason for such an analytical construct in the duty of care context. Instead, a breach of the duty of care should be the end of the liability analysis, with the remaining issue being whether the breach caused monetary damage or warrants another remedy. *See generally* Lyman Johnson, *Rethinking Judicial Review of Director Care*, 24 DEL. J. CORP. L. 787 (1999) (criticizing *Cede* framework). The more straightforward framework should be adopted by Delaware courts for officers from the outset and, in addition, should be adopted for directors in place of the current, unnecessarily prolix *Cede* construct.

120. *See* Securities Act of 1933 [hereinafter 1933 Act] § 20(d), 15 U.S.C. § 77t(d) (2006 & Supp. IV 2010); Securities Exchange Act of 1934 [hereinafter 1934 Act] § 21A(d)(3), 15 U.S.C. § 78u-1(d)(3) (2006).

orders,<sup>121</sup> and barring wrongdoers from further service as an officer or director of a reporting company.<sup>122</sup>

Financial fraud cases by the SEC are usually brought against the company and its officers.<sup>123</sup> Few cases are brought against directors,<sup>124</sup> though recently that agency has targeted certain outside directors in two actions.<sup>125</sup> This is the mirror opposite of litigation under Delaware corporate law, where there are numerous cases against directors and far fewer against officers.<sup>126</sup> Many SEC cases brought against officers concern the usual fare of intentional financial fraud, at least at the charging stage.<sup>127</sup> Frequently, however, it appears that many cases are resolved on negligence grounds, for example, under sections 17(a)(2) and (3) of the Securities Act of 1933, rather than on scienter-based counts.<sup>128</sup>

In 2010, to illustrate, in separate actions against Dell Computer Corp. and several of its officers and against Citigroup, the SEC obtained consent decrees under such a negligent fraud theory.<sup>129</sup> One commentator recently has described these initiatives as the SEC's effort to develop a federal "Caremark duty" to monitor under the federal securities laws, generally aimed at officers.<sup>130</sup> The SEC also has targeted related party transactions and has used the clawback provisions under the Sarbanes-Oxley Act to "claw back" incentive compensation, even where the officer was not involved in the underlying fraud.<sup>131</sup>

The point here is not to assess the merits or demerits of the SEC's strategy. The point simply is that the current legal action against corporate officers is at the federal level, not the state level. This is a less noticed version of the creeping "federalization" of corporate lawmaking than that seen in the corporate law-related provisions of the landmark Dodd-Frank legislation.<sup>132</sup> This has resulted not from

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121. See 1933 Act § 8A, 15 U.S.C. § 77h-1 (2006); 1934 Act § 21C, 15 U.S.C. § 78u-3 (2006 & Supp. IV 2010).

122. See 1933 Act § 20(e), 15 U.S.C. § 77t(e) (2006); 1934 Act § 21C(f), 15 U.S.C. § 78u-3(f) (2006).

123. Thomas O. Gorman, *Trends in SEC Financial Fraud Actions: Part I*, LAW 360 (Apr. 29, 2011, 2:13 PM), <http://www.law360.com/articles/242098/section=securities>.

124. *Id.*

125. Matteo Tonello, *SEC Enforcement Actions Against Outside Directors Remind Boards*, HARV. L. SCH. FORUM ON CORP. GOVERNANCE & FIN. REG. (July 16, 2011, 11:01 AM), <http://blogs.law.harvard.edu/corpgov/2011/07/16/sec-enforcement-actions-against-outside-directors-offer-reminder-for-boards>.

126. Johnson & Garvis, *supra* note 3, at 1106–08.

127. Thomas O. Gorman, *Trends in SEC Financial Fraud Actions: Part II*, LAW 360 (May 6, 2011, 2:19 PM), <http://www.law360.com/articles/242174/section=securities>.

128. *Id.*

129. *Id.*

130. *Id.*; see *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959, 967–70 (Del. Ch. 1996) (director duty to monitor).

131. Gorman, *Trends in SEC Financial Fraud Actions: Part II*, *supra* note 127.

132. Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. No. 111-203, 124 Stat. 1376 (the "Dodd-Frank Act"). Professors Robert Thompson and Hillary Sale have noted this trend as well but emphasize the absence of state law. Robert B. Thompson & Hillary A. Sale, *Securities Fraud as Corporate Governance: Reflections Upon Federalism*, 56 VAND. L. REV. 859, 905–06 (2003). We emphasize here, as before, see Johnson & Millon, *supra* note 4, that agency law long has supplied a body of law applicable to corporate officers but that courts have not fully or extensively articulated legal concepts for officers in a way that differentiates officers (and their duties) from directors.

express disenchantment with state corporate law as such, but from that body of law's sustained and outright neglect of officer conduct. Even though they see fewer officer cases than director cases, we do agree with Mr. Graf that it is "simply a matter of time" before Delaware courts must resolve the open issues associated with officer wrongdoing.<sup>133</sup> When they do so, we hope they craft the law of officer duties in a way that, while realistic, also provides meaningful accountability along the lines advocated here and in earlier work.

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133. Graf, *supra* note 1, at 315.