DIRECTOR INATTENTION AND DIRECTOR PROTECTION UNDER DELAWARE GENERAL CORPORATION LAW SECTION 102(b)(7): A PROPOSAL FOR LEGISLATIVE REFORM

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ABSTRACT

Disinterested directors of Delaware corporations face virtually no threat of personal liability for inattentive corporate decision-making. Among other tools, Delaware General Corporation Law section 102(b)(7) insulates disinterested Delaware directors from personal liability for "merely" inattentive conduct. Yet behavioral psychology research indicates that the threat of punishment is an important motivator of actor behavior. Assuming it is sensible to motivate directors to be engaged, attentive corporate monitors, it is important to revise section 102(b)(7) so that directors face some credible threat of personal liability for inattentive conduct at the corporate helm. In this article, such revisions are proposed in the form of a liability cap. A capped liability statute will encourage Delaware jurists to hold directors accountable for inattentive conduct because the liability exposure of inattentive, but nonvenal, directors will be limited to a reasonable dollar amount that is not draconian.

I. INTRODUCTION

Director inattention is a problem. Many recent high-profile corporate scandals likely could have been prevented by a board of directors that was engaging, inquisitive, and giving its corporate charge due attention. The looting of WorldCom, the implosion of Enron, the irrational explosion of executive compensation, and stock option backdating all involved conduct that could have been detected and remedied by an attentive board of directors. Yet the well-qualified board of directors behind the failed behemoth Enron did not notice or did not care that Enron's senior managers had created a house of cards where Enron's financial infrastructure once stood.[1] The equally

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[1] *See* WILLIAM C. POWERS, JR. ET AL., REPORT OF INVESTIGATION BY THE SPECIAL INVESTIGATIVE COMMITTEE OF THE BOARD OF DIRECTORS OF ENRON CORP. 149-64 (2002) (discussing the failure of the Enron board to make inquiries about conflicted transactions, to

illustrious board of bankrupt WorldCom apparently never became suspicious when WorldCom CEO Bernard Ebbers continually posted extraordinary quarterly results despite being on an aggressive acquisition binge that did not allow time for each newly acquired business to assimilate.[2] In another matter, the board of directors of the Walt Disney Company never collectively deliberated about whether to hire former Disney President Michael Ovitz until after Disney CEO Michael Eisner had signed an agreement hiring Ovitz and issued a press release announcing the hire.[3] When Ovitz was fired a mere fifteen months later with a severance package worth approximately $140 million, the Disney board neither jointly discussed nor formally agreed to the firing because the board did not realize it was their job to make termination decisions regarding senior Disney executives.[4] At best, these boards were poorly overseeing their corporations. At worst, the directors of these boards were wholly asleep at the wheel.

Board inattention is at odds with the basic fact that directors, as fiduciaries, are obligated to act in the best interests of the corporation and its shareholders with "the punctilio of an honor the most sensitive."[5] Apathy is clearly unacceptable in the boardroom, yet it persists. With every corporate

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investigate red flags raised by risky deals, and to ask for more information before voting on a major transaction); *see also* Jonathan R. Macey, *Efficient Capital Markets, Corporate Disclosure, and Enron*, 89 CORNELL L. REV. 394, 417-20 (2004) (reviewing Enron's misleading financial statements and the fact that two-thirds of its debt went undisclosed).

[2]*See* David S. Hilzenrath, *"The Company's Directors Were All Too Often a Passive Rubber Stamp for Management and Especially Mr. Ebbers"; How a Distinguished Roster of Board Members Failed to Detect Company's Problems*, WASH. POST, June 16, 2003, at E1; Shawn Young et al., *Ebbers Lawyer Paints Sullivan as Chronic Liar*, WALL ST. J., Feb. 17, 2005, at C1 (reporting that Scott Sullivan, former CFO of WorldCom, testified that he "misled the board" with relative ease given "that a lot of people weren't even awake, so there wasn't a lot of challenge").

[3]*In re* Walt Disney Co. Derivative Litig., 907 A.2d 693, 707-08 (Del. Ch. 2005) (explaining that the Disney board met for an hour on September 26, 1995, to discuss hiring Michael Ovitz after Disney CEO Michael Eisner had already signed a letter agreement and issued a press release announcing the Ovitz hiring on August 14, 1995).

[4]*Id.* at 736. Ovitz was terminated as of December 12, 1996, yet, as of then, "the Disney board had never met in order to vote on, or even discuss, the termination." *Id.*

[5]Della Ratta v. Larkin, 856 A.2d 643, 658 (Md. 2004) (quoting Meinhard v. Salmon, 164 N.E. 545, 546 (N.Y. 1928)). The *Larkin* court also went on to explain that:

> [m]any forms of conduct permissible in a workaday world for those acting at arm's length are forbidden to those bound by fiduciary ties. A . . . [corporate director] is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate. Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the "disintegrating erosion" of particular exceptions . . . . Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd.

Id. (quoting *Meinhard*, 164 N.E. at 546).

scandal born of director inattention, shareholders lose money. With every major corporate failing, investor confidence and the stability of the capital markets are undermined.

Corporate governance scholars have expounded on the many reasons why boards are often inattentive and ineffective.[6] The more important issue, however, is what can be done to motivate directors to pay attention to their corporate charges. What will inspire inattentive directors to engage, ask questions, and monitor the officers they appointed? This article ultimately concludes that the answer to this question involves necessary modifications to Delaware General Corporation Law (DGCL) section 102(b)(7).

Behavioral research illustrates that actors who face a credible threat of punishment for the failure to perform well or who know they are monitored perform better than those who face no threat of punishment or who do not believe they are being observed.[7] This research is worth considering in the director behavior context and this article posits that monitoring and the threat of punishment via personal liability exposure have the potential to be powerful tools to combat director inattention.

But section 102(b)(7) practically obliterates any credible threat of personal liability punishment for inattentive, disinterested Delaware directors. Indeed, despite the plague of board inattention revealed in recent corporate scandals, the past few years have failed to produce a handful of significant judgments against disinterested Delaware directors who have failed their corporate charges. This vacuum of liability is at odds with behavioral research. This article proposes modifying section 102(b)(7) to allow for broader, but capped, liability exposure for directors who have breached their fiduciary duties. Under my proposal, disinterested directors would face liability for duty of care violations; however, the amount of liability exposure would be capped at an amount that is not draconian.

This article proceeds to that end as follows: Part II of this article discusses the role of a corporation's board of directors, a director's fiduciary duties, and board inattention. In addition, an explanation is provided of how

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[6] *See, e.g.*, Marleen A. O'Connor, *The Enron Board: The Perils of Groupthink*, 71 U. CIN. L. REV. 1233, 1270-93 (2003). Among other things, boards are thought to be crippled by informational and time limits, blinded by groupthink, excessively optimistic, and unwilling to violate counterproductive rules of boardroom etiquette. *See generally infra* note 16; *see also* Betty Joan Thurber, *A Behavioral Science Analysis of Sarbanes-Oxley's Certification Requirements—The Right Kind of Deterrence?*, 7 TRANSACTIONS: TENN. J. BUS. L. 123, 133-39 (2005) (enumerating factors that support and oppose "the Hypothesis that Sarbanes-Oxley Certification Will Deter Officers and Directors from Serving").

[7] *See infra* Part III.

the modern "monitoring" board is a breeding ground for apathy and inattention.

Part III of this article discusses behavioral studies illustrating that both a credible threat of punishment for the failure to perform in a certain way and the awareness of being monitored are powerful tools for influencing behavior. Actors who face punishment if they do not perform satisfactorily or who know their behavior is being monitored are more likely to complete tasks successfully, behave in an appropriate way, and fulfill their obligations. This indicates that director behavior is likely to be enhanced and inattention battled if directors know they are being monitored and face some credible threat of personal liability for their inattention.

In Part IV of this article, section 102(b)(7) and its relevance in the analysis of punishing and monitoring directors are discussed. This part begins by reviewing director liability for inattentive conduct and examining how section 102(b)(7) fits into what has been called a "no liability" liability scheme. Section 102(b)(7) is analyzed with particular attention paid to how it has been used to preclude practically all personal liability for disinterested directors who are asleep at the wheel. This part concludes by suggesting that section 102(b)(7) should be modified to capitalize on the behavioral influence of monitoring and the threat that punishment might have on inattentive and lethargic directors.

Finally, Part V of this article proposes revisions to section 102(b)(7). These revisions create a credible threat of punishment for directors who fail to fulfill their fiduciary duties. Part V suggests that section 102(b)(7) be amended to allow corporations to cap the personal liability exposure of their directors for any fiduciary duty violation (with certain limited exceptions) at the greater of: (a) the amount of the benefit the director received as a result of her fiduciary duty violation; (b) the amount of money, inclusive of bonuses and expenses, that the director received from the corporation in the year or years she breached her fiduciary duty; or (c) $80,000. In addition, section 102(b)(7) should be modified to provide that these capped personal liability amounts cannot be paid by insurance and are not eligible to be indemnified. Part V concludes by countering a few likely arguments against the proposed modifications.

II. THE CORPORATE FORM, THE BOARD OF DIRECTORS, AND INACTION IN ACTION

The structure of the modern, publicly held corporation lends itself to problems of board inattention. Although corporations are owned by shareholders, they are managed by a board of directors elected by the shareholders.[8] This creates a division between ownership (at the shareholder level) and control (at the director level), which raises the classic "other people's money" problem.[9] Directors are managing a corporation representing an investment of "other people's money," yet, in theory, no one does as good a job managing a business as the business owner herself because she has the most at stake.[10]

This "other people's money" problem is compounded by the way the modern board of directors actually fulfills its managerial obligations. While a corporation's board of directors is charged by state statute with the task of managing the business and affairs of the corporation, the board also has statutory authority to delegate management duties to officers selected by the board whom the board then "monitors."[11] The modern board of directors is

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[8]DEL. CODE ANN. tit. 8, § 141(a) (2001) ("The business and affairs of every corporation . . . shall be managed by or under the direction of a board of directors . . . ."); ADOLF A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 117-18 (1932). In managing the business and affairs of the corporation, directors are obligated to satisfy their two fiduciary duties—the duty of care and the duty of loyalty. *See* COX ET AL., CORPORATIONS 197 (1997) ("Directors and officers stand in a fiduciary relationship to their corporation. Their duties are roughly divided into two distinct categories[, the duty of care and the duty of loyalty]."). The duty of loyalty requires a director to prioritize her corporation over her own and other interests. *Id.* at 207-08. The duty of care obligates a director to act with the care an ordinary prudent person in a like position would exercise under similar circumstances. Graham v. Allis-Chalmers Mfg. Co., 188 A.2d 125, 130 (Del. 1963).

[9]Richard Mitchell et al., *Shareholder Value and Employee Interests: Intersections Between Corporate Governance, Corporate Law and Labor Law*, 23 WIS. INT'L L.J. 417, 425 (2005) (finding that the agency problem inherent with directors managing the shareholders' money or "other people's money" "goes back to Adam Smith, who observed that directors in the joint stock company could not be expected to be as vigilant and careful with other people's money as with their own") (citing ADAM SMITH, *Of the Expence of Public Works and Public Institutions*, *in* WEALTH OF NATIONS 244, 260 (Edwin Cannan ed., Univ. Chi. Press 1976) (1776)).

[10]*See* Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288, 288-89 (1980); Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 308 (1976).

[11]DEL. CODE ANN. tit. 8, § 141(c) (2001); Russell Powell, *The Enron Trial Drama: A New Case for Stakeholder Theory*, 38 U. TOL. L. REV. 1087, 1104 (2007) (stating that "shareholders who are the owners of the firm elect directors who hire professional managers to run the day-to-day operations of the corporation"); *accord* Stephen M. Bainbridge, Unocal *at 20: Director Primacy in Corporate Takeovers*, 31 DEL. J. CORP. L. 769, 776 (2006) (pointing out that "[m]anagement rights are assigned by statute solely to the board of directors and those officers to whom the board properly delegates such authority").

thereby a "monitoring" board, with the business of the corporation in the hands of senior corporate officers whose performance is monitored by the board.[12] This monitoring structure removes directors from the daily operations of the corporation and limits the board in two obvious ways: (1) boards do not possess first-hand information on the day-to-day machinations of their corporate charge; and (2) corporate officers, who provide the directors information regarding the corporation's operations, become informational gatekeepers with the power to limit or skew the information they relay to the board.[13]

Because the modern board is a monitoring board and boards manage "other people's money," a director's ability and incentive to be an outstanding director are compromised. It is not surprising, then, that over the past two decades, many boards have proved themselves to be poor monitors. Many have failed to detect and squelch corporate fraud, allowing serious product failings to mar corporate reputations. In addition to a board's inability to detect corporate fraud, boards have tacitly approved a range of questionable accounting, financing, and disclosure practices.[14] Recent corporate scandals dealing with vulgar and inexplicable executive compensation, stock option backdating, and overt looting make manifest the fact that the monitoring board may not be monitoring quite so well. Some corporate boards appear plagued by inattention, and some directors are asleep at the wheel.

Director inattention is troubling at both micro and macro levels. On an individual level, director inattention is a problem because, to the extent that corporations suffer damage due to director inattention, shareholders who hold stock in those corporations lose money when the value of their investment decreases.[15] From a broader perspective, director inattention is a problem because it undermines investor confidence. When investors lose confidence in

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[12]*See* Jeffrey N. Gordon, *The Rise of Independent Directors in the United States, 1950-2005: Of Shareholder Value and Stock Market Prices*, 59 STAN. L. REV. 1465, 1469-70 (2007) (discussing a typical board's role change "from the 'advising board' to the 'monitoring' board" after World War II).

[13]*See* WILLIAM L. CARY & MELVIN ARON EISENBERG, CASES AND MATERIALS ON CORPORATIONS 289 (7th ed. 1995) (discussing the "[c]onstraints of information" facing the modern board of directors).

[14]For details of the spate of corporate scandals that appear to be birthed of oversight failures, see Lisa M. Fairfax, *Form Over Substance?: Officer Certification and the Promise of Enhanced Personal Accountability Under the Sarbanes-Oxley Act*, 55 RUTGERS L. REV. 1, 6-8 (2002); Renee M. Jones, *Law, Norms, and the Breakdown of the Board: Promoting Accountability in Corporate Governance*, 92 IOWA L. REV. 105, 135-39 (2006); Elizabeth A. Nowicki, *Not in Good Faith*, 60 SMU L. REV. 441, 443-45 (2007).

[15]*See, e.g.*, Jonathan H. Gabriel, Note, *Misdirected? Potential Issues with Reliance on Independent Directors for Prevention of Corporate Fraud*, 38 SUFFOLK U. L. REV. 641, 642 (2005) (finding that "the failure of WorldCom cost shareholders a staggering $200 billion").

the management of the modern corporation, they stop investing in stocks and corporations, which tightens capital market liquidity and limits corporate expansion. Further, as an academic matter, director inattention throws into question the utility of the corporation as a business entity. One of the key benefits to the corporate form is that it allows for passive investment because management is the responsibility of directors. If the directors are inattentive, this undermines the utility of passive investment. Corporations utilize a management structure that vests "control" of the corporation into the hands of directors who are elected by shareholders. If directors are not performing their control functions, the corporation is not working as designed.

Many corporate law scholars have sought to explain why so many directors appear to be inattentive, failing to recognize red flags and adequately discharge their oversight responsibilities.[16] This article does not focus on why directors are inattentive but, rather, it focuses on what can be done to combat director inattention. The critical question to ask, when reflecting on boardrooms where directors are dozing off, is: "What can be done to combat director inattention and motivate boards to engage?"[17]

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[16]Some blame director lapses on directors having close ties to management, causing directors to become overly deferential to managers. Rachel A. Fink, *Social Ties in the Boardroom: Changing the Definition of Director Independence to Eliminate "Rubber-Stamping" Boards*, 79 S. CAL. L. REV. 455, 457 (2006); *see also* Patrick J. Ryan, *Rule 14a-8, Institutional Shareholder Proposals, and Corporate Democracy*, 23 GA. L. REV. 97, 177 (1988) ("[T]he nominees for membership on the board of directors are usually selected by the chief executive officer of the corporation, frequently with the help of a director's nominating committee."). Others say that directors, having chosen the officers to whom the directors delegate their management authority, have an optimism bias that cannot be overcome and thus, no director wants to believe the manager she selected was a bad choice. *See, e.g.*, Donald C. Langevoort, *Monitoring: The Behavioral Economics of Corporate Compliance with Law*, 2002 COLUM. BUS. L. REV. 71, 87 ("If the supervisor is the one who hired (or promoted) the agent, discovery of any wrongdoing calls that choice into question. When there is accountability for decisions, people tend to construe information in ways that bolster their prior commitments."). Still others say that directors, most of whom have day jobs other than simply serving as directors, do not have the time available to well serve their corporations. *See* CARY & EISENBERG, *supra* note 13, at 288-89 (discussing a board of directors' "[c]onstraints of time" due to limited meetings throughout the year).

[17]*The Washington Post* quoted Carl Icahn's 1986 account of a director's meeting as follows: "Literally, half the board is dozing off. The other half is reading the *Wall Street Journal*. And then they put slides up a lot and nobody can understand the slides and when it gets dark they all doze off." *Asleep in the Boardroom*, WASH. POST, May 23, 2002, at A32. For the ease with which Scott Sullivan deceived the WorldCom board, see Young et al., *supra* note 2, at C1.

III. BEHAVIORAL PSYCHOLOGY: THE BEHAVIOR-INFLUENCING VALUE OF THE THREAT OF PUNISHMENT AND THE AWARENESS OF BEING MONITORED

The question of how to combat boardroom apathy and motivate directors to engage in their oversight role is not a question of corporate law; it is a question of behavioral psychology. Yet, no responsive body of behavioral research exists. There have been no specific studies examining which independent variables influence director behavior and inspire director attention.[18]

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[18]The closest studies are those performed by organizational behavior management (OBM) experts in which they investigate the most effective ways to motivate rank-and-file employees and managers. *See* Harold W. Babb & Daniel G. Kopp, *Applications of Behavior Modification in Organizations: A Review and Critique*, 3 ACAD. MGMT. REV. 281, 282-83 (1978). *See also* Kirk O'Hara et al., *Organizational Behavior Management in the Private Sector: A Review of Empirical Research and Recommendations for Further Investigation*, 10 ACAD. MGMT. REV. 848, 848-49 (1985) (describing how motivators are defined and how they affect employee behavior); Craig Eric Schneier, *Behavior Modification in Management: A Review and Critique*, 17 ACAD. MGMT. J. 528, 529, 535 (1974) (explaining the effects of "operant techniques" when applied to work settings).

In these studies, researchers have examined ways to alter employee performance by manipulating certain independent variables, such as cash bonuses for better performance, positive feedback, autonomous goal-setting, variable pay schedule, extra vacation, group feedback, opportunity to win prizes, and training or performance demonstration. O'Hara et al., *supra*, at 850-55 tbl.1. The dependent variable studied by these researchers—the employee "performance"—has included the number of rodents trapped by beaver trappers, the incidence of safety problems among almond farm machinery manufacturers, the amount of time spent by insurance claims workers on a given task, the number of trees planted by employees at a tree planting company, the frequency of earplug usage among textile weavers, and the incidence of errors in bobbin production at a yarn mill. *Id.* These studies have shown that, to varying degrees, the performance of employees and managers can be influenced by tinkering with feedback, goal setting autonomy, and compensation structure.

These studies and the results of these studies, however, do not translate well to the director context. These studies do not examine the type of behavior at issue with director inattention because the typical OBM study focuses on quantitatively improving some specific result, such as increasing the number of widgets produced in a day, decreasing the number of safety incidents in a year, or increasing sales in a quarter. With directors, at least for purposes of this article, these sorts of concerns are not at issue. This article is not concerned with assessing how to cause directors to increase a firm's per quarter revenues. Rather, it seeks to ascertain how to motivate directors to ask more questions, monitor officers more closely, and generally pay more attention to their corporations. Also, directors are expected to approve risky decisions that might not always turn out well in terms of widgets produced or profits secured, such that influencing behavior toward a certain quantitative end is not at issue in this article.

Additionally, the manipulated variables in the typical OBM study examining employee performance, such as compensation, extra vacation, and prizes, are not the appropriate variables to manipulate if one wants to study ways to influence director conduct. For example, regarding pay, most directors of large, publicly held corporations have lucrative day jobs aside from their director

That said, behavioral studies conducted outside the director context show that both the threat of punishment and the awareness of being monitored effectively influence actor behavior. For example, in a study comparing the threat of punishment to the promise of reward in motivating actor behavior, researchers examined how a "proposer" shared a sum of money with a "responder" under conditions where the proposer knew the responder had the option to punish, reward, both punish and reward, or neither punish nor reward the proposer based on how much money the proposer offered to share with the responder.[19] The researchers found that proposers who knew they could be

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positions. Thus, manipulating a director's pay or giving the director prizes is not likely to be a compelling way to influence a director's behavior. Similarly, directors tend to serve their corporate charges for relatively few days per year; therefore, OBM studies that manipulate vacation are essentially irrelevant.

The literature from corporate law scholars focusing on director behavior is a bit more extensive than the OBM literature. *See, e.g.*, Margaret M. Blair & Lynn A. Stout, *Director Accountability and the Mediating Role of the Corporate Board*, 79 WASH. U. L.Q. 403, 439-41 (2001); A. Mechele Dickerson, *A Behavioral Approach to Analyzing Corporate Failures*, 38 WAKE FOREST L. REV. 1, 4-7 (2003); Lisa M. Fairfax, *Spare the Rod, Spoil the Director? Revitalizing Directors' Fiduciary Duty Through Legal Liability*, 42 HOUS. L. REV. 393, 427-37 (2005); Donald C. Langevoort, *Behavioral Theories of Judgment and Decision Making in Legal Scholarship: A Literature Review*, 51 VAND. L. REV. 1499, 1515-16 (1998); Edward B. Rock, *Saints and Sinners: How Does Delaware Corporate Law Work?*, 44 UCLA L. REV. 1009, 1018-19 (1997); David A. Skeel, Jr., *Shaming in Corporate Law*, 149 U. PA. L. REV. 1811, 1842, 1859-60 (2001); Lynn A. Stout, *On the Proper Motives of Corporate Directors (Or, Why You Don't Want to Invite* Homo Econimous *to Join Your Board)*, 28 DEL. J. CORP. L. 1, 9-13 (2003). Very little of that literature, however, deals with evidence-based behavioral research on altering director behavior. *But see* Jones, *supra* note 14, at 108-09 (examining social sciences literature dealing with accountability versus reliance on norms).

[19]James Andreoni et al., *The Carrot or the Stick: Rewards, Punishments, and Cooperation*, 93 AM. ECON. REV. 893, 894 (2003). In this study, a proposer and responder were anonymously paired together (they could not see each other and they did not know each other). *Id.* at 894-95. The proposer was given $2.40 and told to share that money with the responder. *Id.* The proposer was obligated to give the responder at least $.40 but could choose to give the responder more than that. *Id.* Proposers were informed that the responder could then adjust what the proposer retained of the $2.40 in response to what the proposer offered to give the responder. *Id.* Based on how the proposer chose to share her $2.40, the responder could punish or reward the proposer. *Id.* at 894.

In response to the proposer's offer, the responder could do one of three things: (1) accept the offer as it was made by the proposer; (2) reward the proposer's offer by increasing the amount the proposer retained (for every $.05 the responder increased the proposer's earnings, the responder lost $.01 of what she would be paid); or (3) decrease the proposer's retained amount as a punishment for a low offer by the responder by "paying" $.01 for every $.05 she decreased the proposer's offer. *Id.* at 894-95.

If, for example, the proposer offered the responder $.90 of the $2.40, leaving the proposer $1.50, the responder might be so offended as to retaliate. The responder could choose to "punish" the proposer by decreasing her retained earnings by $1.00, for example. This would "cost" the responder $.20 ($.01 for every $.05 decrease in the proposer's earnings). The proposer would end up with $.50 ($1.50 minus $1.00), and the responder will end up with $.70 ($.90 minus $.20, the cost for punishing).

punished by the responder for making a small offering to the responder made larger offerings, on average, to the responder than did proposers who did not face punishment by the responder.[20] While the biggest offerings at the margins were made by proposers who knew they could be rewarded by the responder for making a good offering, the group of proposers who faced the threat of punishment for making a small offering made the largest average offerings.[21] In terms of motivating more proposers to make larger offerings to responders, the threat of punishment for meager offerings to the responder was more influential than the promise of rewards for large offerings.[22]

In another study, the behavioral impact of the threat of punishment was examined in the context of task-based performance, whereby sixty children were asked to perform a task subject to one of three reinforcement conditions: (1) subject to rewards only, (2) subject to punishment only, or (3) subject to rewards and punishment.[23] Children who faced the prospect of punishment for the failure to correctly perform the task had higher rates of correct performance than children who did not face the threat of punishment.[24] Interestingly, the study organizers noted that it was unclear whether the threat of punishment was associated with better performance because (a) children who faced

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Not every responder, however, had the option to punish. *Id.* at 894. Some responders had the option to only punish, some responders had the option to punish and/or reward, some responders had the option to only reward the proposer, and some responders had no options in response. *Id.*

[20]*See id.* at 900 fig.7.

[21]*Id.* at 901.

[22]*Id.* at 894.

[23]Kenneth L. Witte & Eugene E. Grossman, *The Effects of Reward and Punishment Upon Children's Attention, Motivation, and Discrimination Learning*, 42 CHILD DEV. 537, 538 (1971). In this study, the children were asked to identify the shape (circle or triangle) of a wooden block that was inside a box that the child could feel but not see. *Id.* at 539. The reward for correctly identifying the block was a token that could be exchanged with other tokens for a toy; however, the punishment for misidentifying a block consisted of a loud, ninety-eight decibel tone. *Id.*

[24]Both the punishment-only group and the punishment-and-reward group had higher correct response rates than the reward-only group. *Id.* at 539-41. The study organizers noted that their results—that performance rates were better when an actor faced punishment than when an actor did not—were consistent with prior research showing that actors perform better in response to the threat of punishment or cost (removal of reward) than in response to the promise of reward. *Id.* For example, in a study conducted by Dr. Derek Wright, eighty school-aged children used a stylus to work through a maze consisting of ten T-junction choice points in front of an examiner under one of four conditions: (1) the examiner said nothing; (2) the examiner gave positive social reinforcement (correct responses were rewarded with "yes, excellent" or "yes, fine" in a "warm and enthusiastic tone of voice"); (3) the examiner used negative social reinforcement (responding to a mistake in the maze trial by saying sharply, with increasing irritation, "no, wrong," "no, that's wrong," or "no, wrong again"); or (4) the examiner used both positive and negative feedback. Derek Wright, *Social Reinforcement and Maze Learning in Children*, 39 CHILD DEV. 177, 179 (1968). Children subject to negative reinforcement alone did better than those subject to only positive reinforcement. *Id.* at 181-82.

punishment were more motivated to get the correct answer to avoid being punished or (b) children who faced the threat of punishment paid more attention to the task at hand as the threat of punishment made it clear to them that the task was important.[25]

Similarly, studies that measure the impact that monitoring has on actor behavior show that actor behavior is better when an actor believes she is being monitored.[26] For example, children who believe they are being watched while they are interacting with peers more frequently proffer "on-task verbalizations" with fewer negative verbalizations and "nonsense verbalizations" than their study counterparts who do not believe they are being watched.[27] Mothers who know that they are being watched are more interactive with their children than mothers who are not informed that they are being observed.[28] Men who are

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[25]Witte & Grossman, *supra* note 23, at 540-41. Indeed, "[a]dditional data suggested that the . . . performance differences were due to attentional, rather than motivational, differences among the [three] groups." *Id.* at 537. For example, during breaks, the children in the punishment group as well as those in the punishment and reward group "remain[ed] oriented toward the [block-containing] apparatus." *Id.* at 541.

[26]This is consistent with the behavioral literature indicating that actors who know they are being observed exhibit behavior distorted by the "social desirability element." Leslie E. Zegiob et al., *An Examination of Observer Effects in Parent-Child Interactions*, 46 CHILD DEV. 509, 509 (1975). This is why direct interviews are sometimes viewed by researchers as an inaccurate way to predict actor behavior—actors often do not answer honestly when asked what they would do in a given circumstance. *See, e.g.*, *id.*

[27]Gene H. Brody et al., *Peer Interaction in the Presence and Absence of Observers*, 55 CHILD DEV. 1425, 1425 (1984). This study involved thirty-six peer pairs who were presented with Loc Blocs, a toy horse, and a Loc Bloc foundation for a toy building and were told to work together to finish a barn for the horse while being observed from behind a mirror. *Id.* at 1425-26. Half of the pairs were put in a playroom to work on this task in the presence of a visible observer; while half of the pairs were in playrooms with no observer present and no knowledge that they were being observed from behind a mirror. *Id.* at 1426. As the pairs played and worked on the barn, observers recorded the number of positive verbalizations, negative verbalizations, directives, social conversation, nonsense verbalizations, task-related verbalizations, and on-task play. *Id.* at 1426 & tbl.1.

Researchers found that the pairs' play and interactive behavior changed markedly in two ways when they knew they were being observed: (1) all behavior except the "on-task" play decreased, and (2) unconstructive behavior—negative verbalizations, social conversation, nonsense verbalization—decreased more significantly than did their directives, positive verbalizations, and task-related verbalizations. *Id.* at 1427-28 & tbl.2. The study investigators concluded that this is consistent with other studies showing that children who know they are being watched behave better and follow instructions more closely. *Id.* at 1428.

[28]Zegiob et al., *supra* note 26, at 511. This study involved twelve mother-child pairs who agreed to be observed as they interacted. *Id.* at 509. The pairs were both observed in a laboratory playroom where they were told they were being observed and also observed via a mirror in a waiting room where they were not told they were being observed. *Id.* at 509-10.

Three behaviors were significantly different when mothers knew they were being observed. First, mothers who knew they were being observed offered more frequent positive verbal feedback. *Id.* at 511. Second, mothers played more with the child when being watched. *Id.* Third, the

obligated to pay child support and who know they are being watched and risk quick detection and jail time for the failure to pay, pay more money, more consistently.[29] Jurisdictions with a "well-oiled enforcement process" for child support payments have a significantly greater percentage of parents under support orders paying regularly than do jurisdictions where a monitoring and enforcement scheme does not exist.[30]

Behavioral research indicates that the threat of punishment, or even just the awareness of having one's behavior monitored, can motivate improved task performance, increased attention, and appropriate or responsible behavior. From this, one can argue that the threat of punishment by way of legal liability should be useful in addressing director inattention and boardroom lethargy.[31] A liability construct under which directors (a) face some threat of personal liability for inattention and (b) believe that they are being monitored by shareholders and their attorneys, who know they have litigation recourse if the directors abdicate their duties, should be a useful tool to combat boardroom lethargy. Section 102(b)(7), as it currently exists, does not serve this end.[32]

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mothers more frequently used "structuring" when they knew they were being watched. *Id.* Structuring included the mother taking an active role in influencing the child's play, by questioning or directing the child's activity. *Id.*

[29]David L. Chambers, *Men Who Know They Are Watched: Some Benefits and Costs of Jailing for Nonpayment of Support*, 75 MICH. L. REV. 900, 902 (1977). Professor David Chambers studied child-support payments by parents under court orders of support in Michigan in order to assess the impact of Michigan's payment monitoring system on payment rates. *Id.* at 900. Each county government in Michigan had an agency that monitored child-support payments, such that the agency knew Monday what parents failed to make their payments on the preceding Friday. *Id.* Professor Chambers found that, year after year, Michigan "collected an average of more per case than any other state in the country." *Id.* at 926. Parents who knew they were being observed paid child support. While Professor Chambers could not assess whether Michigan's superior collection rates were due to signaling cues that child support payment was important or whether it was due to the strong likelihood of being caught due to observation, the study was able to conclude that the upshot of the monitoring system was that it was effective in influencing payment behavior. *Id.* at 926-27.

[30]*Id.* at 901. Similarly, economist Dr. Anindya Sen recently examined the impact on drunk driving when stricter penalties and media publicity of drunken driving instances and their resultant punishment were reported. Anindya Sen, *Do Stricter Penalties or Media Publicity Reduce Alcohol Consumption by Drivers?*, 31 CANADIAN PUB. POL'Y 359, 359 (2005). Dr. Sen concluded that both variables—media focus on drunk driving and its penalties and the actual penalizing of drunk driving—correspond with lower incidences of drunk driving. *Id* at 359, 374.

[31]Both Professor Renee Jones and Professor Lisa Fairfax have recently argued that increased director liability would be useful to reinvigorate corporate boards. *See* Fairfax, *supra* note 18, at 395; Jones, *supra* note 14, at 105. Neither author, however, relied on behavioral studies specifically pertaining to punishment to justify their position.

[32]Forty-seven states have some form of director liability insulation, with most states having statutes that mirror Delaware's section 102(b)(7). DEL. CODE ANN. tit. 8, § 102(b)(7) (2001); Nowicki, *supra* note 14, at 452 n.31. One notable example of a liability insulating provision that does not exactly mirror section 102(b)(7) is Virginia's statute, discussed *infra* note 51. *See* VA. CODE ANN. § 13.1-692.1 (2006).

IV. DIRECTOR LIABILITY AND DELAWARE GENERAL CORPORATE LAW SECTION 102(b)(7)

A director's fiduciary duties obligate her to act in the best interests of her corporation and its shareholders.[33] If a director breaches her fiduciary duties, she can be sued by her shareholders, directly or derivatively, on behalf of the corporation.[34] As a practical matter, however, unless the conduct complained of involved conflicted directors who acted in their own interests or committed fraud or waste, it is difficult for shareholders to move lawsuits forward against directors of Delaware corporations for fiduciary duty violations. Over the past twenty years, lawsuits against disinterested directors who were "merely" asleep at the wheel or apathetic have not been successful.[35] Procedural, common law, and statutory hurdles in these lawsuits have created what some scholars call a "no liability" construct of director liability.[36] Given

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[33]*See generally supra* note 8.

[34]*See* ROBERT CHARLES CLARK, CORPORATE LAW 639-40 (Little Brown and Co. 1986).

[35]Bernard Black et al., *Outside Director Liability*, 58 STAN. L. REV. 1055, 1060-61 (2006) (analyzing outside director liability over the past twenty-five years and concluding that it takes a "perfect storm" to create circumstances under which outside directors are required to pay out-of-pocket liability expenses).

[36]The three hurdles that together create this "no liability" environment are the demand requirement, the business judgment rule presumption, and section 102(b)(7). *See* Jones, *supra* note 14, at 117 (finding that the "cumulative effect" of the statutory, common law, and procedural hurdles facing shareholders suing boards for oversight failures "is a de facto 'no liability' rule for corporate directors"). Regarding the demand requirement, Delaware courts require shareholders who bring a derivative lawsuit to first make a demand on the board of the corporation at issue to allow the board to either fix the problem giving root to the lawsuit or exercise its managerial discretion and decide whether the lawsuit is appropriate and should be brought by the board itself on behalf of the corporation. *See* Aronson v. Lewis, 473 A.2d 805, 811-12 (Del. 1984). Not surprisingly, demand made in such circumstances usually results in the board deciding not to continue the lawsuit against the directors, and courts will usually defer to the board's decision. *Id.* at 813. Even if a derivative lawsuit is maintained beyond this demand requirement, however, the lawsuit is likely to be dismissed by the court due to the protection of the business judgment rule presumption. *Id.* at 814.

The business judgment rule is a presumption in favor of directors whose actions are being attacked, which provides that courts will presume disinterested directors acted within their reasonable business judgment and discretion unless a complaining party can show that the directors' actions were not in good faith, were undertaken on the basis of an information-gathering process that was grossly negligent, or were irrational as a substantive matter. *Id.* at 812. This presumption serves to prevent directors from being second-guessed on the substance of their decisions and it reflects the notion that directors, as statutorily authorized managers of the corporation, should be allowed to exercise their good judgment as they see fit, without fear of being second-guessed, provided that they take care in their information-gathering process and act in good faith. *Id.* If directors act in good faith and employ an information-gathering process that is not grossly negligent, their decisions will withstand attack unless they are irrational. *Id.* I have not found a case in which a Delaware court held that a disinterested director's decision was "irrational"

that this article was written for a symposium on revising the DGCL, it focuses on the hurdle presented by section 102(b)(7).

Section 102(b)(7) allows a corporation to include in its certificate 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," although a director cannot be insulated from liability for "acts or omissions not in good faith" or breaches of the duty of loyalty.[37] This section was adopted just over twenty years ago in the wake of the Delaware Supreme Court's holding in *Smith v. Van Gorkom*,[38] and the majority of

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beyond the protection of the business judgment rule presumption.

[37]DEL. CODE ANN. tit. 8, § 102(b)(7) (2001). A director cannot be protected from liability for acts "which involve intentional misconduct or a knowing violation of law," for acts addressed in DGCL section 174, and "for any transaction from which the director derived an improper personal benefit." *Id.*

[38]488 A.2d 858 (Del. 1985). The *Van Gorkom* court refused to dismiss a fiduciary duty-based lawsuit brought against the directors of the Trans Union Corporation who voted to approve the sale of the company after only a twenty minute presentation regarding the sale by the interested Trans Union CEO. *Id.* at 868. Although the Delaware Court of Chancery dismissed the lawsuit against the directors who hastily approved the sale of the company, finding that the directors were entitled to the protection of the business judgment rule, the Delaware Supreme Court refused to affirm the court of chancery dismissal. *Id.* at 864, 870-71. After the Delaware Supreme Court refused to dismiss the lawsuit against the Trans Union directors, the directors settled the case for $23.5 million—$10 million of which was paid by the Trans Union directors' insurance carrier. R. Franklin Balotti & Mark J. Gentile, *Elimination or Limitation of Director Liability for Delaware Corporations*, 12 DEL. J. CORP. L. 5, 7 n.11 (1987).

The Delaware Supreme Court's refusal in *Van Gorkom* to defer to the actions (or the lack thereof) of the Trans Union board and dismiss the lawsuit against them shocked the Delaware corporate defense bar, who quickly began drafting legislation to insulate corporate directors from liability for fiduciary duty breaches. Nowicki, *supra* note 14, at 478-79. In fact, the actual text of section 102(b)(7) appears to have been drafted by A. Gilchrist Sparks III, the Delaware attorney who was defense counsel in *Van Gorkom*, with the advice of or input from the Corporation Law Section of the Delaware Bar Association. *Id.* at 478 n.140. Such insulation was imperative, it was argued, in order to avoid (1) a drought of available, qualified, willing directors and (2) a director and officer (D&O) liability "insurance crisis." Malpiede v. Townson, 780 A.2d 1075, 1095 (Del. 2001) (stating that section 102(b)(7) "was adopted by the Delaware General Assembly in 1986 following a directors and officers insurance liability crisis and the 1985 Delaware Supreme Court decision in *Smith v. Van Gorkom*"); *see also* Balotti & Gentile, *supra*, at 7-8 (discussing court decisions, including *Van Gorkom*, which led to fears of a D&O liability insurance crisis). On July 1, 1986, a scant year and a half after the Delaware Supreme Court issued its *Van Gorkom* opinion, the Delaware General Assembly adopted section 102(b)(7). *Id.*

The haste with which section 102(b)(7) was adopted by the Delaware legislature is reflected in its virtually nonexistent legislative history. Nowicki, *supra* note 14, at 478 n.140. As I have argued elsewhere, both this haste and the scant legislative history bolster my belief that section 102(b)(7) was an unnecessary piece of reactionary legislation. *See id.* at 471-81. Without reiterating my position in full, I contend that the two main reasons proffered for adopting section 102(b)(7), that there was a D&O liability insurance crisis and that qualified potential directors would not serve absent protection such as the sort offered in section 102(b)(7), have never been substantiated in the statute's meager legislative history or otherwise.

Delaware corporations now have liability-limiting charter provisions.[39] A liability-limiting provision in a corporation's charter compels summary dismissal of duty of care claims for monetary damages asserted against the corporation's disinterested directors,[40] such that the only fiduciary duty claims against a disinterested director that can be litigated are those based on either (a) a duty of loyalty violation or (b) acts or omissions not in good faith.[41]

Historically, the parameters of a duty of loyalty claim have been narrowly drawn by Delaware jurists, who have held that the duty of loyalty is implicated only when a director has acted to benefit herself personally.[42]

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[39]As of 2007, Delaware was home to over sixty percent of the Fortune 500 corporations and fifty percent of all publicly traded companies in the United States. *See* HARRIET SMITH WINDSOR, DEL. DEP'T OF STATE: DIV. OF CORPS. 1 (2007), *available at* http://corp.delaware.gov/2007DivCorpAR.pdf. Most of the approximately three hundred Delaware-incorporated corporations of the Fortune 500 have adopted director-protective charter provisions based on section 102(b)(7). *In re* Walt Disney Co. Derivative Litig., 907 A.2d 693, 752 (Del. Ch. 2005) ("The vast majority of Delaware corporations have a provision in their certificate of incorporation that permits exculpation to the extent provided for by [section] 102(b)(7).").

[40]A certificate of incorporation provision adopted pursuant to section 102(b)(7) operates as an affirmative defense for a defendant director who is sued for violating her fiduciary duties and the director can raise the section 102(b)(7) defense "on a Rule 12(b)(6) motion to dismiss (with or without the filing of an answer), a motion for judgment on the pleadings (after filing an answer), or a motion for summary judgment (or partial summary judgment) under Rule 56 after an answer, with or without supporting affidavits." *Townson*, 780 A.2d at 1092 (footnotes omitted); *see also* Emerald Partners v. Berlin, 787 A.2d 85, 91 (Del. 2001) (stating that "it is appropriate for the Court of Chancery to consider a properly raised Section 102(b)(7) charter provision in a pretrial context" as it is in the "'*nature* of an affirmative defense.'" (quoting Emerald Partners v. Berlin, 726 A.2d 1215, 1223 (Del. 1999))).

[41]Stone v. Ritter, 911 A.2d 362, 367 (Del. 2006) (explaining that a section 102(b)(7) provision in a corporation's certificate of incorporation "can exculpate directors from monetary liability for a breach of the duty of care, but not for conduct that is not in good faith or a breach of the duty of loyalty").

[42]*Walt Disney Co.*, 907 A.2d at 751 ("The classic example that implicates the duty of loyalty is when a fiduciary either appears on both sides of a transaction or receives a personal benefit not shared by all shareholders."). I say "historically" because the recent decision in *Stone* indicates that a director's duty of loyalty can be implicated in circumstances beyond simply those in which a director is clearly conflicted. *Stone*, 911 A.2d at 370.

Stone was a derivative lawsuit based on oversight failures. The complaining shareholders alleged that their directors breached their fiduciary duties because AmSouth Bancorporation (AmSouth) lacked a reporting system designed to ensure compliance with the federal Bank Secrecy Act. *Id.* at 365. AmSouth had in its certificate of incorporation an exculpatory provision for its directors based on section 102(b)(7), such that the personal monetary liability of the AmSouth directors hinged on whether the acts or omissions at issue were "not in good faith" or in violation of the directors' duty of loyalty. *Id.* at 367. The Delaware Court of Chancery dismissed the claim, and the Delaware Supreme Court affirmed, saying " [o]nly a sustained or systematic failure of the board to exercise oversight . . . will establish the lack of good faith that is a necessary condition to liability." *Id.* at 369 (footnotes omitted). The court continued on to state that "the fiduciary duty of loyalty is not limited to cases involving a financial or other cognizable fiduciary conflict of interest. It also encompasses cases where the fiduciary fails to act in good faith." *Id.* at 370. While the

Inattentive but disinterested directors who serve a corporation with a section 102(b)(7) liability-limiting provision have traditionally only faced personal monetary liability for acts "not in good faith" (or worse).[43] In the more than twenty years since section 102(b)(7)'s adoption, not a single Delaware jurist has found that a disinterested director acted "not in good faith" such that the director was beyond the protections of a charter provision and personally liable to the corporation for monetary damages. This is curious, particularly given the range and temerity of corporate board failings over the past decade. One cannot help but wonder if Delaware jurists are simply unwilling to impose personal monetary liability for fiduciary duty violations on directors who are not conflicted and, if so, why?

One particularly interesting theory is a phenomenon referred to as "judicial nullification," which explains the absence of personal liability.[44] Under this theory, some posit that Delaware jurists will not impose personal liability for fiduciary duty violations in cases that do not involve clear self-interest abuses, regardless of what the law requires, because the damages disinterested directors will have to pay once liability is established are thought to be draconian and disproportionate to the wrongful conduct.[45] Directors who

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failure to act in good faith does not, in and of itself, constitute a fiduciary duty violation, good faith "is a subsidiary element[,] i.e., a condition, of the fundamental duty of loyalty." *Id.* (quotations omitted). Therefore, "[w]here directors fail to act in the face of a known duty to act, thereby demonstrating a conscious disregard for their responsibilities, they breach their duty of loyalty by failing to discharge that fiduciary obligation in good faith." *Id.* (footnote omitted).

Only once in the two years since *Stone* was decided has a Delaware jurist intimated that perhaps he would use the *Stone* language to hold a disinterested but inattentive director accountable under the "duty of loyalty." *See* Ryan v. Lyondell Chem. Co., No. 3176-VCN, 2008 Del. Ch. LEXIS 105, at *48 (Del. Ch. July 29, 2008). It is too soon to tell if the *Stone* opinion has meaningful implications in terms of expanding the duty of loyalty. *See, e.g.*, Stephen M. Bainbridge et al., *The Convergence of Good Faith and Oversight*, 55 UCLA L. REV. 559, 604 (2008); Claire A. Hill & Brett H. McDonnell, Essay, Stone v. Ritter *and the Expanding Duty of Loyalty*, 76 FORDHAM L. REV. 1769, 1777 (2007).

[43]The *Stone* decision might confuse the heuristics used when considering cases that involve disinterested directors who have failed in their oversight obligations, but the *Stone* holding will not change the substance of a section 102(b)(7) analysis. Hill & McDonnell, *supra* note 42, at 1795-96. Oversight failures that put directors outside the protection of section 102(b)(7) must be deemed duty of loyalty violations or acts not in good faith in order to place the actions beyond the protection of section 102(b)(7).

[44]Summarizing the judicial nullification theory, Professor Renee Jones has said:

> One reason that corporate law fails to effectively deter nonfeasance may be the enormous scope of potential liability for directors, which detracts from the legitimacy of the corporate liability scheme. . . . The disproportionate (and arguably undeserved) penalties that can be imposed for breach of fiduciary duty create a risk of nullification that has been realized in corporate law.

Jones, *supra* note 14, at 148-49.

[45]John C. Coffee, Jr. & Donald E. Schwartz, *The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform*, 81 COLUM. L. REV. 261, 317 (1981) (stating that "courts have proven remarkably reluctant to impose liability where no element of self-dealing or

are found to have breached their fiduciary duties are personally liable for the entire amount of damages to the corporation, often exceeding tens of millions of dollars, such that Delaware jurists simply refuse to follow the law and impose personal liability for monetary damages on inattentive, but not venal, disinterested directors.[46]

Whatever the reason that Delaware jurists have never held disinterested directors personally liable for monetary damages for fiduciary duty violations, the important point is that section 102(b)(7) as it currently exists and is interpreted helps insulate disinterested directors from almost any credible threat of personal liability for their acts or omissions. This runs counter to the behavioral research showing that both (a) a credible threat of punishment for the failure to perform and (b) an awareness of being monitored motivate attentive actor behavior and improve task performance.[47] This article therefore proposes below modifications to section 102(b)(7) that will harness the behavior-influencing power of monitoring and the threat of punishment.[48]

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personal benefit was present"); Jones, *supra* note 14, at 148 (explaining that when facing a liability scheme with harsh penalties, "courts may be unwilling to impose the legal sanctions called for under existing law").

[46]In the recent *Disney* litigation surrounding the hiring, firing, and compensation of former Disney president Michael Ovitz, the directors were alleged to have cost the corporation approximately $130 million by failing to adequately oversee the hiring and firing of Ovitz. *In re* Walt Disney Co. Derivative Litig., 906 A.2d 27, 35 (Del. 2006). Had the court found that the directors acted "not in good faith" and beyond the protection of their section 102(b)(7)-based charter provision, the seventeen directors would have been liable for over $7.5 million each (assuming all of the directors were able to pay their full share). *Id.* (referencing $130 million severance payout awarded to Ovitz).

[47]As alluded to in *supra* note 38, the legislative history for section 102(b)(7) is sparse. There is no mention in the legislative history of the Delaware legislature's consideration of the notion that it was ill-advised to almost absolutely allow directors to be insulated from personal liability for fiduciary duty violations. Nowicki, *supra* note 14, at 478-79 & n.140.

[48]This statement assumes that achieving the positive behavioral effects associated with the threat of punishment and monitoring in the corporate boardroom, such as increased attention and better oversight, is desirable. This assumption is reasonable because directors, as fiduciaries, are obligated to act with diligence and attention. Extrinsic factors that encourage fiduciaries to fulfill their obligations seem sensible. That said, when I presented a very early draft of this article to the faculty at the University of Missouri-Columbia School of Law, I was asked by an audience member whether I had empirical evidence to support the notion that a corporation's performance would improve if its directors were more attentive. Is it possible, I was asked, that corporations with attentive directors might actually be hindered? The question is interesting, but it is not necessary for me to answer the question to justify my position that director inattention should be addressed. As noted above, director inattention is not consistent with a director's fiduciary obligations, regardless of the qualitative impact of a director's attention on a corporation's performance.

V. PROPOSED MODIFICATIONS TO SECTION 102(b)(7)

A complete repeal of section 102(b)(7) is not worth proposing because the Delaware legislature and judiciary seem committed to being perceived as friendly to corporations and directors.[49] Suggestions of moderate revision instead are appropriate, and, to that end, the Delaware legislature should replace the current language of section 102(b)(7) with the following language authorizing a corporation to include in its charter:

> A provision limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of a fiduciary duty to the greatest of (i) the benefit received by the director as a result of the fiduciary duty violation, (ii) the compensation received by the director from the corporation in the year or years of the fiduciary duty violation, or (iii) $80,000; provided that such a provision shall not limit a director's liability for willful misconduct, for a knowing violation of the law (including, without limitation, any claim of unlawful insider trading or manipulation of the market for any security), or under section 174 of this title; and provided that the amounts in (i), (ii), or (iii) cannot be indemnified and cannot be insured.

These amendments would broaden the scope of conduct for which a director could be held personally liable,[50] while capping the dollar amount of a

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[49]Delaware's local newspaper reported:

> When it comes to selling Delaware as the pre-eminent legal home for Corporate America, [Delaware] Supreme Court Chief Justice Myron Steele knows how to seal the deal. Last summer, the justice hosted an elegant dinner at his [Delaware] farm for two Australian lawyers [who were there] to learn about the latest developments in Delaware law.

Maureen Milford, *Delaware's Corporate Dominance Threatened*, NEWS J., Mar. 2, 2008, at A1 (discussing the fact that one-third of Delaware's revenue is from incorporation fees providing a possible incentive for Delaware to be solicitous of corporate managers); *see also* Diana B. Henriques, *Top Business Court Under Fire: Critics Say Politics is Hurting Delaware Judiciary*, N.Y. TIMES, May 23, 1995, at D1 (analyzing the controversy surrounding the Delaware governor's decision not to reappoint Delaware Supreme Court justice Andrew Moore and the intimations that the decision was motivated by pressure from powerful procorporation defense lawyers).

[50]As discussed in *supra* Part IV, section 102(b)(7) has been interpreted to insulate directors from all liability for duty of care violations. My proposed amendments would eliminate this liability insulation so that directors would face capped duty of care liability.

For lack of a better place to make mention, I believe section 102(b)(7) has been misinterpreted to preclude liability for duty of care violations. The more accurate reading of the language of the statute is that it allows a director to be protected from duty of care liability for all

director's personal liability exposure.[51] In terms of the amounts proposed for

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duty of care claims other than those premised on an act or omission "not in good faith." DEL. CODE ANN. tit. 8, § 102(b)(7) (2001). While this might seem to be a semantic quibble, the reality is that, if jurists and academics keep misstating that a section 102(b)(7) provision precludes duty of care liability, that misinterpretation of the statute is likely to become entrenched such that it becomes, in effect, a legal reality.

[51]Professors John C. Coffee, Jr. and Donald E. Schwartz made a similar proposal over twenty-five years ago and the American Law Institute's draft of *Principles of Corporate Governance* then included a director liability cap. Coffee, Jr. & Schwartz, *supra* note 45, at 318 n.306.

While this particular liability cap proposal did not gain traction, the general concept of a liability cap was not completely lost. In 1998, for example, former SEC Commissioner A.A. Sommer, Jr. suggested that "protections for directors should be limited by providing that a director could be held liable for monetary damages equaling the value of one, two, or three years of directors' fees." *Speaker Declares Duty of Care to Be "Dead"; The Good News is Directors Don't Know it*, 12 CORP. COUNS. WKLY. (BNA) 7 (Dec. 24, 1997). This, Sommers suggested, would help "put some teeth into the duty of care." *Id.* Both Professor Renee Jones and Professor Lisa Fairfax have recently penned articles advocating for the reinvigoration of a director's personal liability for fiduciary duty violations. Professor Fairfax indicates support for the notion of capping a director's liability exposure. Fairfax, *supra* note 18, at 454. Professor Jones suggests that "calibrat[ing]" a director's liability by pegging it to a percentage of the director's net worth is sensible. Jones, *supra* note 14, at 152.

Virginia has a liability cap statute, adopted in 1987, that is much more protective than the cap I am proposing, providing:

> A. In any proceeding brought by or in the right of a corporation or brought by or on behalf of shareholders of the corporation, the damages assessed against an officer or director arising out of a single transaction, occurrence or course of conduct shall not exceed the lesser of:
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> 1. The monetary amount, including the elimination of liability, specified in the articles of incorporation or, if approved by the shareholders, in the bylaws as a limitation on or elimination of the liability of the officer or director; or
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> 2. The greater of (i) $100,000 or (ii) the amount of cash compensation received by the officer or director from the corporation during the twelve months immediately preceding the act or omission for which liability was imposed.
>
> B. The liability of an officer or director shall not be limited as provided in this section if the officer or director engaged in willful misconduct or a knowing violation of the criminal law or of any federal or state securities law, including, without limitation, any claim of unlawful insider trading or manipulation of the market for any security.
>
> C. No limitation on or elimination of liability adopted pursuant to this section may be affected by any amendment of the articles of incorporation or bylaws with respect to any act or omission occurring before such amendment.

VA. CODE ANN. § 13.1-692.1 (2006).

Note that, contrary to section 102(b)(7), Virginia's statute is not an opt-in statute. *Compare* DEL. CODE ANN. tit, 8 § 102(b)(7) (2001) (permitting corporations to shield personal director liability for breaches of fiduciary duties), *with* VA. CODE ANN. § 13.1-692 (2006) (operating as a mandatory cap on the liability exposure of both corporate officers and directors). If a Virginia corporation does not cap the liability of its directors and officers by way of charter or bylaw provision, the statute's mandatory cap (the greater of the actor's cash compensation or

the cap, the first two amounts—"the benefit received by the director" and "the compensation received by the director"—are based on fiduciary principles, and the third amount is based on common sense. A fiduciary is not allowed to use her position for personal gain, and common law has long required disgorgement of such personal gains.[52] It is both sensible and justifiable, then, to use disgorgement of gain as a measure for capping personal liability.

In a related vein, the faithless servant doctrine provides that an employee who has been disloyal or disobedient can be forced to repay her compensation for the period during which she has been faithless.[53] It is from this doctrine that the second proposed damages measure is drawn.[54] The third proposed measure for capping liability, $80,000, is suggested in light of the fact that the wording of the proposed cap includes the phrase "the greatest of." A director's liability would be capped at "the greatest of" the three amounts and if a director gained no benefit from her inattention, receiving only nominal compensation for the year or years during which she breached her fiduciary duty, some other number is needed at which to cap liability that would provide some level of punishment, else the "threat of punishment" would be lacking. The $80,000 amount was selected because a significantly greater number

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$100,000) will apply. VA. CODE ANN. § 13.1-692(a)(1)-(2) (2006).

Under the "race to the bottom" theory, one would have thought that Virginia's director and officer protection would have lured the bulk of the Fortune 500 corporations away from Delaware. Perhaps directors, officers, and corporate lawyers never noticed that Virginia has "out-Delawared" Delaware.

[52]Excelsior 57th Corp. v. Lerner, 553 N.Y.S.2d 763, 764-65 (N.Y. App. Div. 1990) (stating that "where claims of self-dealing and divided loyalty are presented, a fiduciary may be required to disgorge any ill-gotten gain even where the plaintiff has sustained no direct economic loss"). This disgorgement rule serves a deterrent purpose:

> It is true that the complaint before us does not contain any allegation of damages to the corporation but this has never been considered to be an essential requirement for a cause of action founded on a breach of fiduciary duty. This is because the function of such an action, unlike an ordinary tort or contract case, is not merely to compensate the plaintiff for wrongs committed by the defendant but, as this court declared many years ago "to *prevent* them, by removing from agents and trustees all inducement to attempt dealing for their own benefit in matters which they have undertaken for others, or to which their agency or trust relates."

Diamond v. Oreamuno, 248 N.E.2d 910, 912 (N.Y. 1969) (quoting Dutton v. Willner, 52 N.Y. 312, 319 (N.Y. 1873)).

[53]*See, e.g.*, Jet Courier Serv., Inc. v. Mulei, 771 P.2d 486, 500 (Colo. 1989) (finding that forfeiture of compensation applies in cases involving disloyal acts to the company).

[54]Similarly, the Sarbanes-Oxley Act requires disgorgement of certain bonuses paid to a corporation's chief executive officer and chief financial officer if the corporation has to prepare an accounting restatement due to material noncompliance with financial reporting requirements. Sarbanes Oxley Act, 15 U.S.C. § 7243 (2006). Professor Fairfax also suggests forcing directors to "disgorge" their compensation if they have breached their fiduciary duty. Fairfax, *supra* note 18, at 454-55.

might deter directors from serving while a significantly lesser number is unlikely to be viewed as a credible threat of punishment.[55]

The proposed amendments would also preclude indemnification or insurance for the capped liability amounts. Obviously the punishment aspect of director liability is undercut if a director who is found liable for breaching her fiduciary duties does not have to pay damages out of her own pocket. Given that proposed revisions are born of the behavioral research showing that the threat of punishment influences actor behavior, it makes little sense to allow directors to avoid punishment through insurance and indemnification.

The biggest benefit of the proposed revisions to section 102(b)(7) should be more motivated, attentive directors and better oversight in the boardroom. In addition, the price of D&O insurance should plummet if section 102(b)(7) is modified to include a liability cap because insurers will not be responsible for any of the capped amount, and unlimited director liability exposure for acts "not in good faith" will cease to exist. As well, the proposed modifications would address the tension Delaware jurists confront between holding directors as fiduciaries to high behavioral standards and saddling directors who are not conflicted with crushing personal liability for nonvenal acts. As discussed above, as the statute currently exists, if a director is found to have acted "not in good faith" outside the protection of section 102(b)(7), the director is jointly and severally accountable for all of the resulting damage to the corporation. If amended as proposed, section 102(b)(7) would provide for more moderate personal liability, such that jurists should not be reluctant to hold accountable a disinterested director who might not have acted deliberately to hurt her corporate charge but who violated her fiduciary duties nonetheless. Limiting a director's liability to the greatest of the amount she received as a benefit of breaching her fiduciary duties, the compensation she received from the corporation in the year(s) she breached her fiduciary duties, or $80,000 will address concerns about damages being totally disproportionate to the offending conduct.

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[55]Admittedly, the selection of $80,000 was a bit arbitrary because neither the empirical data nor the behavioral research necessary to precisely calculate an effective cap while not dissuading directors from serving exists. As noted above, Virginia's statute imposes a mandatory cap of $100,000 for directors who received less than $100,000 in cash compensation from their corporation, unless the corporation has taken the initiative to identify a lower cap in its charter or bylaws, such that $80,000 superficially seems reasonable.

Liability caps generally raise a host of concerns,[56] as does the idea of imposing personal liability on directors for fiduciary duty violations.[57] Some argue that liability caps are inherently unjust because they can deprive an injured party of full recovery of the damages suffered.[58] This begs the question of the purpose of awarding damages in litigation against directors for fiduciary duty violations. It is generally agreed that recovery in fiduciary duty lawsuits is more about deterrence than about making the corporation or its shareholders whole.[59] Indeed, there tends to be little relationship between the amount recovered and the harm suffered.[60] Moreover, even if the appropriate compensation of injured corporations or shareholders was the goal of monetary liability for fiduciary duty breaches, the reality is that, given the judicial disinclination to hold disinterested directors accountable at all for fiduciary duty violations, monetary liability and resultant compensation is unlikely to be achieved under Delaware's existing liability construct. Capping liability to create a scheme more likely to be enforced by jurists is, therefore, more likely to create a credible threat of punishment for disinterested directors. This seems more effective than having a liability scheme that, while not capped, is eschewed by jurists.[61]

Another concern related to liability caps is that lawyers will be unwilling to take otherwise meritorious cases that are subject to caps. Because attorneys' fees in fiduciary duty lawsuits against directors are often calculated, in part,

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[56]One oft-repeated argument against liability caps generally is that they weaken the deterrent aspect of tort liability by decreasing the penalty for committing a tort. *See* Note, *"Common Sense" Legislation: The Birth of Neoclassical Tort Reform*, 109 HARV. L. REV. 1765, 1772-75 (1996). This argument is not terribly relevant when discussing director liability in Delaware given that the Delaware legislature is unlikely to totally repeal section 102(b)(7) to allow for the deterrent effect of unlimited personal liability of directors for fiduciary duty violations. As discussed above, Delaware does not currently have a liability scheme for disinterested directors that is enforced. Thus, the deterrent effect of a liability scheme will not be reduced by my cap proposals. Rather, as alluded to above, in the case of disinterested director liability, a cap might well increase deterrence by increasing the chances courts will hold a director liable.

[57]Assaf Hamdani & Reinier Kraakman, *Rewarding Outside Directors*, 105 MICH. L. REV. 1677, 1689 (2007) (discussing the potential for "a diminished pool of candidates from which to recruit new directors" and "the agency cost of risk-distorted decision-making by the board" if directors are held liable for duty of care violations).

[58]Nancy L. Manzer, *1986 Tort Reform Legislation: A Systematic Evaluation of Caps on Damages and Limitations on Joint and Several Liability*, 73 CORNELL L. REV. 628, 638 (1988).

[59]*See* Coffee, Jr. & Schwartz, *supra* note 45, at 304-05.

[60]*Id.* at 304 n.240 (discussing specific nominal recoveries per share in litigated fiduciary duty cases).

[61]Indeed, having a fiduciary duty liability scheme that is not enforced strikes some scholars as inherently troubling because it undermines the legitimacy of fiduciary duty obligations and behaviorists argue that refusing to enforce liability is worse, from a deterrence standpoint, than not having standards or a threat of liability at all. *See* Jones, *supra* note 14, at 150.

based on the recovery achieved, one might fear that capped recovery will dissuade good attorneys from taking even compelling fiduciary duty cases.[62] This fear would be unfounded, however, because Delaware courts have discretion in awarding attorneys' fees in shareholder litigation against directors.[63] If liability exposure for fiduciary duty violations is capped, attorneys for the plaintiff-shareholders who request an award of fees could argue for fees based not on the amount recovered in the lawsuit but rather on the intangible benefit to the corporation for vindicating a wrong, or alternatively, on the hours spent on the litigation. Modifications to section 102(b)(7) that cap liability could also include language authorizing the payment of reasonable attorneys' fees by the corporation or its insurer to plaintiffs' counsel based on calculations not related to the dollar amount of recovery.[64]

Regarding the general opposition some may surely have to modifying section 102(b)(7) to allow for personal liability of disinterested directors for duty of care violations (albeit capped liability), the refrains that motivated the adoption of section 102(b)(7) will likely resurface. Modification opponents will argue that without complete liability insulation the pool of qualified directors will evaporate and directors who are not totally insulated from liability will make inefficient, overly cautious decisions.[65] As discussed previously, however, both arguments are red herrings.[66] Professionals in a variety of industries face personal liability without fear and there is nothing about directors that entitles them to special protection. Moreover, if liability exposure is capped, fear of liability becomes even less credible. In addition, the duty of care has always been interpreted generously, such that directors who make well-considered decisions that turn out poorly have never faced duty of care liability. Directors will not make overly cautious decisions if duty of care liability exists because their lawyers will counsel them that a rich history

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[62]A comprehensive discussion of attorneys' fees and the influence they have on derivative litigation is far beyond the scope of this article. For an article on the fascinating topic, see Jonathan R. Macey & Geoffrey P. Miller, *The Plaintiffs' Attorney's Role in Class Action and Derivative Litigation: Economic Analysis and Recommendations for Reform*, 58 U. CHI. L. REV. 1 (1991).

[63]*See, e.g.*, Chrysler Corp. v. Dann, 223 A.2d 384, 386 (Del. 1966); Franklin Balance Sheet Inv. Fund v. Crowley, No. 888-VCP, 2007 Del. Ch. LEXIS 133, at *27 (Del. Ch. Aug. 30, 2007).

[64]*See, e.g.*, 49 U.S.C.S. § 32,710(b) (LexisNexis 2008) (authorizing award of attorneys' fees for successful plaintiffs).

[65]*See* Hamdani & Kraakman, *supra* note 57, at 1689.

[66]*See* Nowicki, *supra* note 14, at 481; *see also* Jones, *supra* note 14, at 155 (arguing that "the WorldCom and Enron settlements are significant, yet not severe enough to create the impression of unjust punishment").

of precedent protects directors who make risky but planned, considered decisions.[67]

VI. CONCLUSION

In summary, behavioral research indicates that section 102(b)(7)'s practically absolute bar on director liability for fiduciary duty violations by disinterested directors merits reconsideration. Unlimited director liability is likely unrealistic for the Delaware legislature, but a modification of section 102(b)(7) that allows for fiduciary duty liability across all classes of violations (duty of care, duty of loyalty, and acts not in good faith) with a cap on the amount of damages a director can be held accountable for personally is a reasonable compromise between Delaware's director-protective ethos and the reality that the fear of punishment is an important performance motivator.

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[67]For example, over 170 years ago, a New York jurist opined that:

> [e]ven if a loss had accrued as a direct and immediate consequence of [the directors'] error, still, without any other fault on their part, the law, from the wisest policy, would excuse them. No man, who takes upon himself an office of trust or confidence for another or for the public, contracts for any thing more than a diligent attention to its concerns (sometimes differing in degree) and a faithful and honest discharge of the duty which it imposes. He is not supposed to have attained infallibility; and does not, therefore, stipulate that he is free from error. To hold that the law requires this of any man is to suppose him incapable of erring; and to establish it as a rule that men are to be responsible for mistake or error of judgment, while acting in good faith, would put an end to all offices of trust—since no one who is capable or worthy could be found to accept of them.

Scott v. Depeyster, 1 Edw. Ch. 513, 534-35 (N.Y. Ch. 1832).