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SHAREHOLDER POLICE POWER: SHAREHOLDERS' ABILITY
TO HOLD DIRECTORS ACCOUNTABLE
FOR INTENTIONAL VIOLATIONS OF LAW

BY THOMAS A. UEBLER*

ABSTRACT

This article is about the duty of corporate directors to obey the law and how shareholders can hold boards accountable for their illegal acts. It is based on an assumption that there are situations in which it is rational, strictly from a profit-maximizing standpoint, for companies to violate the law. The article surveys numerous internal and external constraints that limit directors' decisionmaking authority and impose on directors a duty to obey the law. The author concludes that knowing violations of law should create a presumption of bad faith under Delaware's fiduciary duty principles, but they should not per se be deemed to breach the directors' duty of care. Thus, shareholder-plaintiffs who can prove that directors acted illegally and caused damages to the corporation that exceed related gains should be entitled to monetary relief on behalf of the corporation from the director-defendants. Shareholders therefore have the opportunity, or perhaps the responsibility, to enforce the social norm of lawful behavior through derivative litigation.

I. INTRODUCTION

America's system of free enterprise, with all its risk and all its rewards is a strength of our country, and a model for the world. Yet free markets are not a jungle in which only the unscrupulous survive, or a financial free-for-all guided only by greed. The fundamentals of a free market—buying and selling, saving and investing—require clear rules and confidence in basic fairness.

- President George W. Bush¹

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¹Signing of the Sarbanes-Oxley Act of 2002 (July 30, 2002), <http://www.whitehouse.gov/news/releases/2002/07/20020730.html>.

Corporate directors have a duty to obey the law, and shareholders should be able to hold directors accountable for intentional violations of law.² The duty to obey the law is separate and distinct from the duty of oversight as defined in *Caremark*³ and *Stone v. Ritter*.⁴ The acts considered in this article involve directors' informed decisions to cause a corporation to violate the law, presumably under a belief that the act is in the best interests of the corporation. It is assumed that there are situations in which it is rational, strictly from a profit-maximizing standpoint, for companies to violate the law.⁵ It is conceded that corporate directors are not likely to document decisions that cause their corporation to violate the law and, with the increase of independent directors on corporate boards, decisions that cause a corporation to act illegally may be less likely to occur. Further, lawbreaking may be more likely to occur at the officer level. But overzealous directors, if given the opportunity, could decide to violate the law. With proper evidence, those decisions could be proved. Shareholders' lawsuits under these circumstances would likely be derivative in nature because the harm would be to the corporation and not to shareholders individually.⁶

²This article attempts to answer many of the questions posed by Professor Stephen Bainbridge in a post to his blog. Bainbridge concludes that "the illegality of a board decision—standing alone—should not result in liability," but he leaves many questions unanswered. Stephen Bainbridge, *Does an Intentional Violation of Law = Bad Faith?*, PROFESSORBAINBRIDGE.COM (June 8, 2006), http://www.professorbainbridge.com/2006/06/does_an_intenti_1.html.

³*In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959 (Del. Ch. 1996). For a thorough analysis of *Caremark* and its duty of oversight, see Hillary A. Sale, *Monitoring Caremark's Good Faith*, 32 DEL. J. CORP. L. 719 (2007).

⁴911 A.2d 362, 370 (Del. 2006) (adopting *Caremark's* oversight liability standard).

⁵According to Franklin A. Gevurtz,

[T]here may be situations in which, from a purely profit maximizing standpoint, it might make sense for a company to disobey a law. This would occur if the profits the corporation could make from engaging in the illegal conduct, multiplied by the probability of not getting caught, exceeded the sanctions the company would face under the law, multiplied by the probability of getting caught in the illegal conduct.

FRANKLIN A. GEVURTZ, CORPORATION LAW 313 (2000). The American Law Institute (ALI), however, "rejects any cost-benefit justification for lawbreaking." Norwood P. Beveridge, *Does the Corporate Director Have a Duty Always to Obey the Law?*, 45 DEPAUL L. REV. 729, 730-31 (1996). ALI believes that "[w]ith few exceptions, dollar liability is not a 'price' that can properly be paid for the privilege of engaging in legally wrongful conduct . . . [and a] cost-benefit analysis whether to obey the rule is out of place." ALI, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 2.01(b)(1) cmt. g (1992). To be clear, the author does not endorse law violation under any circumstances.

⁶Bainbridge, *supra* note 2; *see also* Tooley v. Donaldson, Lufkin & Jenrette, Inc., 845 A.2d 1031, 1035 (Del. 2004). One can distinguish direct from derivative claims by asking, "Who suffered the alleged harm—the corporation or the suing stockholder individually—and who would receive the benefit of the recovery or other remedy?" *Id.*

This article treats violations of criminal law and violations of civil regulation equally. The potential injury to the corporation is similar in either case, and therefore the consequences for directors should be the same. In 2001, Geoffrey Rapp provided the following example of a corporate board's alleged violation of law:

On November 5, 1999, a federal district judge in Washington, D.C. handed down a decision suggesting that the software megafirm Microsoft had engaged in illegal anti-competitive business practices for two decades. . . . One immediate consequence of the judge's ruling was that the value of Microsoft stock plummeted, falling by nearly five percent in the following week and a half. The media paid little attention to the possibility that [the decrease in stock value] (rather than the judge's legal findings) could prompt litigation against Microsoft.⁷

It is also possible, according to several commentators, that the board of directors of a shipping company would order its drivers to disobey speed limits or to double park in delivery zones for faster deliveries and greater business volume.⁸ For example, in 1994, the United Parcel Service of America board of directors allowed its drivers to incur more than \$1.5 million in parking tickets in New York City.⁹ Or, perhaps, a television or radio company's board of directors would choose to violate a Federal Communications Commission content-based regulation to increase its share of viewers, even if the company could incur a fine. There are indeed many examples of corporate lawbreaking in many different industries that could provide shareholders with the opportunity to bring derivative suits against directors.¹⁰

⁷Geoffrey Rapp, *On the Liability of Corporate Directors to Holders of Securities for Illegal Corporate Acts: Can the Tension Between the "Net-Loss" and "No-Duty-to-Disclose" Rules Be Resolved*, 7 FORDHAM J. CORP. & FIN. L. 101, 101-02 (2001) (citations omitted).

⁸ALI provides the following scenario:

I Trucking Company is a publicly held corporation with annual earnings of approximately \$5-7 million. I explicitly instructs its drivers to drive at 75 miles per hour, well in excess of speed limits, because on the basis of due investigation the relevant corporate decision maker concludes that I would increase its net earnings by \$400,000-\$500,000 annually if its trucks were operated at the faster speed.

ALI, PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 5, § 2.01(b)(1) cmt. g, illus. 10; *see also* Bainbridge, *supra* note 2 (suggesting that a shipping company's board of directors might instruct the company's drivers to double park illegally for efficiency purposes).

⁹Beveridge, *supra* note 5, at 731.

¹⁰Most recently, shareholders of Chiquita Brands International alleged that the company's directors breached their fiduciary duties when they "repeatedly approved the payment of millions of dollars in bribes to known Columbian terrorist groups even though they knew it was a federal

Part II of this article discusses numerous internal and external constraints that limit directors' decisionmaking authority and impose a duty upon directors to obey the law. Part III considers which fiduciary duties are implicated by a director's informed decision to violate the law. It concludes that a knowing violation of law should not per se be deemed to breach the duty of care, but that it should create a presumption of bad faith. Issues related to the imposition of personal liability on directors, such as the applicability of the business judgment rule and plaintiff-shareholders' obligation to prove illegality, actual damages, and causation, are explored in Part IV. Finally, Part V concludes that shareholders have the opportunity, or perhaps the responsibility, to enforce the social norm of lawful behavior through derivative litigation.

II. CONSTRAINTS ON THE AUTHORITY OF CORPORATE DIRECTORS

Any discussion of directors' authority under Delaware law must begin with the central premise that "[t]he business and affairs of every corporation . . . shall be managed by or under the direction of a board of directors . . ."¹¹ However, directors' management authority is limited by multiple internal and external constraints.¹² The constraints considered below are not exhaustive, but taken together, they impose a duty upon directors to obey the law.

A. *Fiduciary Duties*

The Michigan Supreme Court observed nearly one century ago that "[a] business corporation is organized and carried on primarily for the profit of the stockholders" and that "[t]he powers of the directors are to be employed for that end."¹³ In Delaware, it is settled law that corporate directors are duty bound to act in the best interests of the corporation and its shareholders.¹⁴ The "duty of care and duty of loyalty are the traditional hallmarks of a fiduciary

crime." *Suit Brands Chiquita a Supporter of Columbian Terrorists*, 23 No. 9 Andrews Corp. Off. & Directors Liab. Litig. Rep. 4 (Oct. 29, 2007) (discussing *Phila. Pub. Employees Ret. Sys. v. Aguirre*, No. 07-851 (S.D. Ohio complaint filed Oct. 11, 2007)). In response, the company claimed "that failure to make payments to both left- and right-wing organizations in Columbia would place the lives of its employees at risk at a time when kidnappings and murders were frequent . . ." *Id.* The federal court will determine whether the directors should be liable "for the damages their actions have caused." *Id.*

¹¹DEL. CODE ANN. tit. 8, § 141(a) (2005).

¹²*See generally* ALI, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS 3 (Tentative Draft No. 8, 1988) (listing a "variety of social and market forces" that constrain directors' conduct).

¹³*Dodge v. Ford Motor Co.*, 170 N.W. 668, 684 (Mich. 1919).

¹⁴*See* *Malone v. Brincat*, 722 A.2d 5, 10 (Del. 1998); *Guth v. Loft, Inc.*, 5 A.2d 503, 510 (Del. 1939).

who endeavors to act in the service of a corporation and its stockholders."¹⁵ The fiduciary duties of care and loyalty are outlined below, along with the recently formulated duty to act in good faith.

1. Duty of Care

The duty of care "requires that directors of a Delaware corporation 'use that amount of care which ordinarily careful and prudent men would use in similar circumstances'"¹⁶ The duty of care concerns directors' decisionmaking *process*, not the substance of their decisions.¹⁷ The standard in Delaware for determining whether a director has breached his duty of care is gross negligence.¹⁸ A board's informed decision will withstand a duty of care challenge unless its substance cannot be "attributed to any rational business purpose."¹⁹

2. Duty of Loyalty

"[T]he duty of loyalty mandates that the best interest of the corporation and its shareholders takes precedence over any interest possessed by a director, officer or controlling shareholder and not shared by the stockholders generally."²⁰ The Delaware Supreme Court recently made clear in *Stone v. Ritter* that, contrary to traditional thinking, the "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."²¹ Alleged breaches of the duty of loyalty are generally scrutinized by courts under the entire fairness standard of review.²²

¹⁵Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 367 (Del. 1993).

¹⁶*In re* Walt Disney Co. Derivative Litig., 907 A.2d 693, 749 (Del. Ch. 2005) (quoting *Graham v. Allis-Chalmers Mfg. Co.*, 188 A.2d 125, 130 (Del. 1963)), *aff'd*, 906 A.2d 27 (Del. 2006).

¹⁷*Id.* at 749-50; *see also* *Brehm v. Eisner*, 746 A.2d 244, 264 (Del. 2000) ("Due care in the decisionmaking context is *process* due care only.").

¹⁸*Smith v. Van Gorkom*, 488 A.2d 858, 873 (Del. 1985) (citing *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984)).

¹⁹*Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del. 1971).

²⁰*Technicolor*, 634 A.2d at 361.

²¹*Stone v. Ritter*, 911 A.2d 362, 370 (Del. 2006).

²²*Weinberger v. UOP, Inc.*, 457 A.2d 701, 710 (Del. 1983) ("The requirement of fairness is unflinching in its demand that where one stands on both sides of a transaction, he has the burden of establishing its entire fairness, sufficient to pass the test of careful scrutiny by the courts."); *cf. In re* Wheelabrator Tech., Inc. S'holders Litig., 663 A.2d 1194, 1205 (Del. Ch. 1995) (applying business judgment standard of review to duty of loyalty claim where an interested transaction involving a noncontrolling shareholder was approved by disinterested directors).

3. Duty to Act in Good Faith

The duty "to act in good faith does not establish an independent fiduciary duty that stands on the same footing as the duties of care and loyalty."²³ Bad faith can take several different forms, with varying degrees of culpability. A director acts in "subjective bad faith" when his actions are "motivated by an actual intent to do harm" to the corporation.²⁴ An "intentional dereliction of duty" or "a conscious disregard for one's responsibilities" also are "legally appropriate, although not . . . exclusive, definition[s] of fiduciary bad faith."²⁵ In *Disney's* post-trial opinion, Chancellor Chandler stated:

The good faith required of a corporate fiduciary includes not simply the duties of care and loyalty . . . but all actions required by a true faithfulness and devotion to the interests of the corporation and its shareholders. A failure to act in good faith may be shown, for instance, where the fiduciary intentionally acts with a purpose other than that of advancing the best interests of the corporation, *where the fiduciary acts with the intent to violate applicable positive law*, or where the fiduciary intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties.²⁶

B. Criminal Liability

Corporations are required, "to the same extent as a natural person, to act within the boundaries set by law."²⁷ "There is no question that the corporation itself is liable to criminal prosecution and punishment for crimes committed by its managers and agents; the United States Supreme Court long ago rejected the nineteenth century doctrine that a corporation cannot have criminal intent."²⁸ A corporation that violates the law may be fined, "and even 'put to

²³*Stone*, 911 A.2d at 370. Corporate directors' duty "to act in good faith 'is a subsidiary element[.]' i.e., a condition, 'of the fundamental duty of loyalty.'" *Id.* (quoting *Guttman v. Huang*, 823 A.2d 492, 506 n.34 (Del. Ch. 2003)).

²⁴*In re Walt Disney Co. Derivative Litig.*, 906 A.2d 27, 64 (Del. 2006).

²⁵*Id.* at 66-67 (citing *In re Walt Disney Co. Derivative Litig.*, 907 A.2d 693, 755 (Del. Ch. 2005)).

²⁶*Disney*, 907 A.2d at 755 (emphasis added). The Chancellor's language was cited with approval by the Delaware Supreme Court on appeal. *Disney*, 906 A.2d at 67 (noting that the Chancellor's examples "echo pronouncements our courts have made throughout the decades").

²⁷ALI, PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 5, § 2.01(b)(1).

²⁸*Beveridge, supra* note 5, at 730 (citing *N.Y. Cent. & Hudson River R.R. v. United States*, 212 U.S. 481, 494-95 (1909)).

death' under the Federal Sentencing Guidelines, which allow imposition of a fine sufficient to divest the organization of all of its net assets in an appropriate case."²⁹ In addition to liability for the company, "corporate directors and officers who violate laws, including by ordering the corporation to break the law, face the sanctions which the particular law imposes on those who violate it."³⁰ Therefore, the threat of criminal penalties, to some extent, deters illegal conduct, and criminal law imposes an affirmative obligation on corporations and directors to act within its boundaries.

C. Other Constraints

Directors' decisionmaking is also constrained by the parameters set forth in a corporation's governing instruments, such as its certificate of incorporation and its bylaws, and, possibly, its corporate philosophy. Decisionmaking is also subject to restrictions imposed by the Delaware General Corporation Law (DGCL),³¹ federal legislation,³² stock market rules and expectations,³³ and public opinion. Finally, a director's own moral compass³⁴ may limit what actions he will take to advance the interests of the corporation.

While the constraints discussed above may influence corporate directors' decisionmaking, and impose a general obligation to obey the law, only directors' fiduciary duties will provide shareholders with a basis for seeking personal liability against directors who cause a corporation to violate the law. The next part discusses which fiduciary duties may be breached by a knowing violation of law.

²⁹*Id.* (citing Edward Felsenthal, *Corporate Death Sentence*, WALL ST. J., May 20, 1994, at B6).

³⁰GEVURTZ, *supra* note 5, at 313 (citing MODEL PENAL CODE § 2.07(6)(a) (2001)). Gevurtz also notes that

some states' criminal statutes contain express provisions which make it clear that a person who performs, or causes to be performed, a criminal act on behalf of a corporation is responsible to the same extent as if he or she engaged in the act on his or her own behalf.

Id. at 313 n.95 (citing N.Y. PENAL LAW § 20.25 (2007)); *see also* 1 KATHLEEN F. BRICKY, CORPORATE CRIMINAL LIABILITY ch. 5 (2d ed. 1992) (discussing liability of directors for illegal corporate conduct).

³¹DEL. CODE ANN. tit. 8, §§ 101-398 (2001).

³²*See, e.g.*, Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002) (codified as amended in various sections of 11, 15, 18, 28 & 29 U.S.C.).

³³*See, e.g.*, N.Y. STOCK EXCH., INC., LISTED COMPANY MANUAL (2003), *available at* http://www.nyse.com/lcm/lcm_section.html; *see also* NASDAQ STOCK MARKET, INC., MARKET-PLACE RULES (2004), *available at* <http://www.nasdaq.com/about/marketplacerule.pdf>.

³⁴"Moral compass" is defined as "anything which serves to guide a person's decisions based on morals or virtues." WEBSTER'S NEW MILLENNIUM DICTIONARY OF ENGLISH, PREVIEW ED. (2007), *available at* <http://dictionary.reference.com/browse/moral%20compass>.

III. DIRECTORS' DUTY TO OBEY THE LAW

Delaware courts have not had the opportunity to analyze the source of corporate directors' duty to obey the law or when personal liability for a breach will result.³⁵ The Delaware Court of Chancery has recognized that "one cannot act loyally as a corporate director by causing the corporation to violate the positive laws it is obliged to obey."³⁶ Vice Chancellor Strine recently noted that "by consciously causing the corporation to violate the law, a director would be disloyal to the corporation and could be forced to answer for the harm he has caused."³⁷ The Vice Chancellor said that directors "have no authority knowingly to cause the corporation to become a rogue, exposing the corporation to penalties from criminal and civil regulators" and "that it is utterly inconsistent with one's duty of fidelity to the corporation to consciously cause the corporation to act unlawfully."³⁸ While Delaware courts clearly condemn this species of director misconduct, it is unclear how shareholders may seek relief in Delaware courts. Outside Delaware, "[c]ourts have created a muddled law governing the liability of corporate directors to holders of securities for the illegal acts of a corporation."³⁹ The subject appears to be underdeveloped in the academic literature, perhaps because "[c]onflicting judicial opinions have led the media, and perhaps even legal scholars, to shy away from the topic."⁴⁰

The Court of Appeals for the Third Circuit in *Miller v. AT&T* held that "even though committed to benefit the corporation, illegal acts may amount to a breach of fiduciary duty in New York."⁴¹ In *Miller*, the plaintiffs' complaint alleged that AT&T's directors' decision not to collect a \$1.5 million debt from the Democratic National Committee following its 1968 convention constituted an illegal campaign contribution.⁴² The court held that the plaintiff-

³⁵Delaware is not alone. Professor John Coffee pointed out thirty years ago that there were no modern cases imposing liability for deliberate law violation by corporate directors. John C. Coffee, Jr., *Beyond the Shut-Eyed Sentry: Toward a Theoretical View of Corporate Misconduct and an Effective Legal Response*, 63 VA. L. REV. 1099, 1173 (1977). Vice Chancellor Strine did note in *Guttman*, without further analysis, that the duty of "legal fidelity" is a subsidiary element of the duty of loyalty. *Guttman v. Huang*, 823 A.2d 492, 505 n.34 (Del. Ch. 2003).

³⁶*Guttman*, 823 A.2d at 505 n.34.

³⁷*Desimone v. Barrows*, 924 A.2d 908, 934 (Del. Ch. 2007).

³⁸*Id.*

³⁹Rapp, *supra* note 7, at 102.

⁴⁰*Id.* (citations omitted).

⁴¹507 F.2d 759, 762 (3d Cir. 1974) (applying New York law) (citing *Roth v. Robertson*, 118 N.Y.S. 351 (N.Y. Sup. Ct. 1909)).

⁴²*Id.* at 761.

shareholders' complaint had stated a cause of action.⁴³ The court, however, did not analyze which duty may have been breached.

This part discusses which duty under Delaware law—due care or loyalty (under its duty to act in good faith)—may be breached by a director's decision to violate the law.⁴⁴ This part also considers whether directors' decisions to cause the corporation to act illegally, alone, are sufficient to prove a breach of fiduciary duty. In other words, it addresses whether a plaintiff is required to prove an independent breach of fiduciary duty (e.g., uninformed or irrational decisionmaking) in addition to proving the illegality of the director's act.⁴⁵ Although it may prove to be inconsequential in practice,⁴⁶ knowing violations of law should create a presumption of bad faith, but they should not per se be deemed to breach the duty of care. Furthermore, proof of a knowing violation of law, alone, should be sufficient to state a claim for breach of fiduciary duty.

⁴³*Id.* at 763.

⁴⁴Professor Melvin Eisenberg suggested almost twenty years ago that the duty to obey the law may act as a freestanding, independent duty. He explained, "Corporate directors and officers are under three general legal duties: the duty to act carefully, the duty to act loyally, and the duty to act lawfully." Melvin A. Eisenberg, *The Duty of Care of Corporate Directors and Officers*, 51 U. PITT. L. REV. 945, 945 (1990). This article assumes that the duty to act lawfully is properly understood as a subcategory of the traditional fiduciary duties of corporate directors, rather than a freestanding, independent fiduciary duty. This position is supported by the Practising Law Institute (PLI), albeit for different reasons. PLI believes that "the duty to obey the law [] is like the duty of good faith (and may be considered to be a part of good faith) insofar as it may represent only a subcategory of the duty of care." JAMES A. FANTO, *DIRECTORS' AND OFFICERS' LIABILITY* § 2:2.3[C] (2d ed. 2006). While it is probably incorrect, as a general rule, to consider the duty to obey the law a subcategory of the duty of care, PLI recognizes that the duty to obey the law does not stand alone as an independent fiduciary duty.

⁴⁵In his corporation law treatise, Gevurtz asks,

[S]hould courts treat [decisions to violate the law] the same as any other decision made by directors or officers—in other words, should a plaintiff need to prove that the directors or officers did not reasonably investigate the decision or could not rationally believe that the decision was in the best interest of the corporation—or, does the mere fact that directors or officers decided to have the corporation engage in illegal conduct make the decision a violation of the directors' or officers' duty to the corporation?

GEVURTZ, *supra* note 5, at 314.

⁴⁶Even if intentional violations of law were deemed to breach the duty of care, directors would not be exculpated under a section 102(b)(7) provision because that statute exempts from exculpation directors who intentionally violate the law. *See* DEL. CODE ANN. tit. 8, § 102(b)(7). Thus, recognizing an intentional violation of law as a breach of the duty of care (and not bad faith) would not shield directors from monetary liability to shareholders, and it would not be "director-friendly" to deem intentional law violation a per se breach of the duty of care rather than a breach of the duty to act in good faith. The distinction may therefore only be significant in theory, not in practice.

*A. An Intentional Violation of Law Should Not
Per Se Be Deemed to Breach the Duty of Care*

There are several arguments supporting the idea that the duty to obey the law functions as a subcategory of the duty of care. For example, the ALI believes that "with very limited exceptions, a director who knowingly causes the corporation to disobey the law violates his duty of care."⁴⁷ Additionally, Franklin Gevurtz offers the following negligence per se argument: "Once[] a court makes the presumption that the legislature knew what it was doing in setting sanctions, it inevitably follows that any officer or director acts unreasonably in exposing the corporation to the risk of such sanctions, and, therefore, breaches his or her duty of care."⁴⁸ This argument, however, cannot be reconciled with Delaware law.

The duty of care is process oriented, and a court will only conclude that a director has breached his duty of care based on the substance of his decision if no rational person would make the decision under the circumstances.⁴⁹ While Gevurtz's argument—that lawbreaking is unreasonable—may be true, it does not follow that all lawbreaking will breach the duty of care.⁵⁰ Within the broad universe of rationality, i.e., the standard for breach of the duty of care based on substance, there can be decisions that are unreasonable.⁵¹ Thus, because an unreasonable decision could theoretically fall within the outer bounds of rationality, it does not follow under Delaware law that an

⁴⁷Beveridge, *supra* note 5, at 729 (citing ALI, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 2.01 (b)(1) cmt. g & 4.01 cmt. d (1992)); *see also* Rapp, *supra* note 7, at 106 ("Directors who knowingly cause the corporation to disobey the law, under the American Law Institute's Principles of Corporate Governance, violate their fiduciary duty of care.").

⁴⁸GEVURTZ, *supra* note 5, at 315.

⁴⁹*In re* Walt Disney Co. Derivative Litig., 906 A.2d 27, 74 (Del. 2006) (citing *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del. 1971)).

⁵⁰Under traditional negligence per se concepts, the violation of a statute is negligence. But just as statutes "may be interpreted as fixing a standard of care for all members of the community, from which it is negligence to deviate," the violation of such statutes "stamp[s] the defendant's conduct as negligence, with all of the effects of common law negligence, but with no greater effect." *Toll Bros. v. Considine*, 706 A.2d 493, 495 (Del. 1998) (citing W. PAGE KEETON ET AL., PROSSER AND KEETON ON THE LAW OF TORTS § 36, at 220, 230 (5th ed. 1984)). As discussed below, however, substance-based duty of care liability in Delaware requires more than "common law negligence."

⁵¹This concept was explored by Vice Chancellor Strine, in the context of *Unocal's* intermediate standard of review, in *In re* Gaylord Container Corp. S'holder Litig., 753 A.2d 462 (Del. Ch. 2000). *See also* Official Comm. of Unsecured Creditors of Integrated Health Serv., Inc. v. Elkins, No. 20,228-NC, 2004 Del Ch. LEXIS 122, at *64 n.92 (Del. Ch. Aug. 24, 2004) ("The Court . . . must determine that the action is *beyond unreasonable*; it must determine that the action was *irrational*." (emphasis added)); 1 R. FRANKLIN BALOTTI & JESSE A. FINKELSTEIN, THE DELAWARE LAW OF CORPORATIONS AND BUSINESS ORGANIZATIONS § 4.30, at 4-138 (3d ed. supp. 2006) (stating that the "rational business purpose" test "is broader than the gross negligence test applied to the process used by the board in reaching its decision").

unreasonable decision to violate the law will always be irrational. Therefore, for a knowing and informed violation of law to breach the duty of care, a court must conclude, based on all evidence available, that the decision was irrational. For reasons of predictability and judicial economy, it is better to adopt the bright line rule suggested below, concerning bad faith, than to require courts to engage in ex post "rationality" inquiries based on speculative cost-benefit analyses.

A knowing violation of law can be rational from a purely financial standpoint, and it can result from an informed, deliberate decisionmaking process which weighs the costs of lawbreaking and the chances of being caught against its benefits.⁵² If directors' fully informed violations of law may be deemed to breach the duty of care, courts will be required to enter the realm of substantive review of director decisionmaking. Once there, they would use the benefit of hindsight to determine whether a board's decision to violate the law crossed the nebulous line between mere unreasonableness and irrationality. Therefore, with Delaware's focus on process under the duty of care and courts' reluctance to evaluate in hindsight the substance of directors' decisions, a well-informed decision to violate the law should not per se be deemed to breach the duty of care.

*B. An Intentional Violation of Law Should Create
a Presumption of Bad Faith*

Professor Stephen Bainbridge asked on his blog whether an intentional violation of law is bad faith conduct. Bainbridge suggested, contrary to Professor Gordon Smith's belief that Delaware's definition of bad faith includes intentional violations of law, that intentional violations of law ought not constitute bad faith per se.⁵³ This part supports Bainbridge's argument that intentional violations of law should not constitute bad faith per se, but it concludes that intentional law violation should create a rebuttable presumption of bad faith.

In *Disney*, the Delaware Supreme Court suggested that knowing violations of law by corporate directors constitute subjective bad faith.⁵⁴ This assertion, however, should not apply to all instances of law violation. First, the good faith discussion in *Disney* appeared to be dicta.⁵⁵ Second, one could

⁵²See GEVURTZ, *supra* note 5, at 313.

⁵³Bainbridge, *supra* note 2.

⁵⁴*In re Walt Disney Co. Derivative Litig.*, 906 A.2d 27, 67 (Del. 2006) ("By its very terms [DGCL section 102(b)(7)(ii)] distinguishes between 'intentional misconduct' and a 'knowing violation of law' (*both examples of subjective bad faith*) . . .") (emphasis added).

⁵⁵See Bainbridge, *supra* note 2.

argue that the Delaware Supreme Court's assertion should apply only when a knowing violation of law is coupled with intent to harm the corporation. As the *Disney* court explained, subjective bad faith is "fiduciary conduct motivated by an actual intent to do harm."⁵⁶ However, *Disney's* categorical assertion overlooks instances where directors could decide to violate the law in an attempt to grow shareholder wealth.

One could also argue that the Delaware General Assembly did not intend illegal acts to equal bad faith. Under DGCL section 102(b)(7), a corporation's certificate of incorporation may contain:

[a] provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, provided that such provision shall not eliminate or limit the liability of a director . . . for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of the law.⁵⁷

The legislature did not say acts not in good faith *such as* a knowing violation of law. Rather, it made clear that acts not in good faith and knowing violations of law were two separate circumstances under which directors would not be exculpated. Therefore, it is at least possible that the legislature did not intend for a knowing violation of law—alone—to constitute an act not in good faith.

Under the Delaware Supreme Court's recent decisions in *Disney* and *Stone*, however, an illegal act by corporate directors should create a presumption of bad faith. The constraints on director decisionmaking, discussed above in Part II, can be divided into two general categories: external constraints and internal constraints. External constraints are those derived from sources outside the corporate enterprise, such as criminal and civil law. Internal constraints are those derived from sources inside the corporate enterprise, such as the certificate of incorporation, corporate bylaws, fiduciary duties, corporate philosophy, and the duty to maximize corporate wealth. It appears to be clear from Chancellor Chandler's definition of bad faith, adopted by the Delaware Supreme Court in *Disney*, that a "conscious disregard" of either an external or internal duty can breach the duty to act in good faith.⁵⁸

The duty to obey the law should not be considered a freestanding duty that arises solely from directors' fiduciary status. Rather, the duty to obey the law is derived from the external and internal constraints discussed above in

⁵⁶*Disney*, 906 A.2d at 64.

⁵⁷DEL. CODE ANN. tit. 8, § 102(b)(7) (2001) (emphasis added).

⁵⁸*In re Walt Disney Co. Derivative Litig.*, 907 A.2d 693, 755 (Del. Ch. 2005).

Part II. Criminal and civil laws, which are external constraints, require corporations to follow the same rules that all persons, natural or legal, must follow.⁵⁹ Similarly, a corporation's certificate of incorporation, an internal constraint, likely permits the corporation to engage only in *lawful* acts.⁶⁰ When a director causes his corporation to violate the law, absent good faith reliance on an expert's opinion regarding legality, he has acted in bad faith because he has intentionally disregarded his external and internal duties to obey the law. Notwithstanding the Delaware Supreme Court's assertion in *Disney*, however, intentional violations of law should not be considered *subjective* bad faith absent evidence of intent to harm the corporation or its shareholders. Rather, intentional violations of law should create a presumption of bad faith under the "conscious disregard" standard because directors will have acted in direct contravention to their external duty to obey the law and their internal duty to cause the firm to act lawfully.

The presumption, however, can be rebutted. Good faith reliance on counsel's opinion that the act was legal or that the illegality of the act was reasonably disputed should rebut the presumption of bad faith. One commentator has noted that directors' ability to rely on legal counsel's advice has provided a strong defense to shareholder actions.⁶¹ Under DGCL section 141(e):

⁵⁹See *supra* Part II.B. Delaware's criminal code applies to corporations where appropriate. DEL. CODE ANN. tit. 11, § 222(21) (2001) ("Person' means a human being who has been born and is alive, and, where appropriate, a public or private corporation.").

⁶⁰DEL. CODE ANN. tit. 8, § 102(a)(3) ("It shall be sufficient to state [in the certificate of incorporation], either alone or with other businesses or purposes, that the purpose of the corporation is to engage in *any lawful act or activity* for which corporations may be organized under the General Corporation Law of Delaware . . .") (emphasis added). For a discussion of the traditional ultra vires doctrine and how it could apply to intentional violations of law, see GEVURTZ, *supra* note 5, at 315, stating that "the notion that illegal acts are ultra vires could still apply for the purpose of holding corporate officials liable on the grounds that agents, who have a corporation engage in an ultra vires activity, are liable for any damages the corporation suffers as a result." See also Kent Greenfield, *Ultra Vires Lives! A Stakeholder Analysis of Corporate Illegality (With Notes on How Corporate Law Could Reinforce International Law Norms)*, 87 VA. L. REV. 1279, 1281-82 (2001) ("Because unlawful acts are ultra vires—'beyond the power' of the corporation—such activities become subject to the enforcement powers of corporate law, in addition to the enforcement powers of whatever governmental or private entity is charged with enforcing the underlying, substantive legal requirement."). Further discussion of the ultra vires doctrine is not necessary here because this article argues that a director's decision to violate the law implicates the (indisputably alive and well) duty to act in good faith.

⁶¹Rapp, *supra* note 7, at 106-07 n.25 ("Where corporate directors relied on the opinion of counsel as to the legality of the corporation's behavior, they are only liable to the extent that their reliance was unreasonable.") (citing *Spirt v. Bechtel*, 232 F.2d 241, 246-48 (2d Cir. 1956)). *But see* *Valeant Pharm. Int'l v. Jerney*, 921 A.2d 732, 751 (Del. Ch. 2007) ("Although 'reasonable reliance on expert counsel is a pertinent factor in evaluating whether corporate directors have met a standard of fairness in their dealings with respect to corporate powers,' its existence is not outcome determinative of entire fairness.") (citation omitted).

A member of the board of directors, or a member of any committee designated by the board of directors, shall, in the performance of such member's duties, be fully protected in relying in good faith upon . . . such information, opinions, reports or statements presented to the corporation by any of the corporation's officers or employees, or committees of the board of directors, or by any other person as to matters the member reasonably believes are within such other person's professional or expert competence and who has been selected with reasonable care by or on behalf of the corporation.⁶²

As one scholar has noted,

Even where the directors have caused the corporation to break [the law], resulting in a criminal conviction of the corporation and its directors, they are still not liable in a shareholder's derivative action for damage to the corporation where they did not know or have reason to know that their actions were unlawful.⁶³

Further, directors should be required to show that their reliance was reasonable, because "where the directors have relied on the opinion of counsel as to the legality of a course of action, they are not liable for resulting damage to the corporation unless their reliance was unreasonable."⁶⁴ Thus, if directors can prove they reasonably relied on the opinion of counsel concerning legality, the presumption of bad faith should disappear.

It should not be sufficient, however, to rebut the presumption of bad faith by showing that the illegal act was undertaken with the subjective belief that it was in the best interests of the corporation, or that it actually benefited the corporation. The Delaware Court of Chancery has made clear that "a fiduciary may not choose to manage an entity in an illegal fashion, even if the fiduciary believes that the illegal activity will result in profits for the entity."⁶⁵ Professor Bainbridge, on the other hand, notes that "it is not self-evident that corporate law should hold directors accountable simply for deciding that the

⁶²DEL. CODE ANN. tit. 8, § 141(e) (2005).

⁶³Beveridge, *supra* note 5, at 740 (citing *Simon v. Socony-Vacuum Oil Co.*, 38 N.Y.S.2d 270, 272-73 (Sup. Ct. 1942), *aff'd*, 47 N.Y.S.2d 589 (N.Y. App. Div. 1944)).

⁶⁴*Id.* at 740-41 (citing *Schwartz v. Romnes*, 495 F.2d 844, 848 n.5 (2d Cir. 1974)); *Spirt*, 232 F.2d at 246-48).

⁶⁵*Metro Comm'n Corp. BVI v. Advanced Mobilecomm Tech., Inc.*, 854 A.2d 121, 131 (Del. Ch. 2004).

corporation's interests are served by violating a particular statute."⁶⁶ However, because subjective motivation to *harm* the corporation is not required for a finding of bad faith (it represents only one bad faith prong, i.e., subjective bad faith), subjective motivation to *better* the corporation should not save illegal conduct from the presumption of bad faith. While positive corporate gain resulting from illegal acts should decrease the extent of directors' liability,⁶⁷ it should not retroactively change the bad faith nature of an illegal act at the time it was committed.⁶⁸ Therefore, unlike good faith reliance on counsel's opinion, subjective motivation to better the corporation, or proof of corporate gains, should not rebut the presumption that the directors acted in bad faith.

IV. DIRECTORS' LIABILITY FOR ILLEGAL CORPORATE ACTS

This part discusses what plaintiff-shareholders should be required to prove in order to hold director-defendants personally liable for knowing violations of law. "The conventional wisdom seems to be that the shareholders may have the right to hold the board of directors liable if it was the directors that caused the corporation to break the law."⁶⁹ Further, "[t]here does not seem to be any question . . . that directors are and should be liable where they *knowingly and unreasonably* violate the law and cause damage to the corporation as a result."⁷⁰ This part concludes that the director-friendly

⁶⁶Bainbridge, *supra* note 2.

⁶⁷See *infra* Part IV.B.2.

⁶⁸This is not a departure from traditional fiduciary duty law. Courts must first determine whether a duty, e.g., loyalty, has been breached, *and then* they consider appropriate damages. Allowing corporate gains to retroactively turn bad faith conduct into good faith conduct would change the accepted, linear practice of judicial review under Delaware law.

⁶⁹Beveridge, *supra* note 5, at 730 (citing *Miller v. AT&T*, 507 F.2d 759, 762 (3d Cir. 1974)). Some commentators contemplate a de minimis exception for minor violations. See Bainbridge, *supra* note 2. Such an exception is likely unnecessary, however, because shareholder litigation contains an inherent de minimis exception. Because of the expense, procedural obstacles, and difficulty of proving the elements of a derivative claim (especially one possibly involving directors' subjective motivations), "only significant violations have any chance to serve as the basis for a successful derivative suit." Patrick J. Ryan, *Strange Bedfellows: Corporate Fiduciaries and the General Law Compliance Obligation in Section 2.01(a) of the American Law Institute's Principles of Corporate Governance*, 66 WASH. L. REV. 413, 488 (1991).

⁷⁰Beveridge, *supra* note 5, at 741 (emphasis added). This article assumes that all knowing violations of law—at least under traditional notions of negligence per se—could be considered unreasonable. As discussed above, however, under the duty of care, Delaware courts will not second guess directors' *unreasonable* decisions, only their *irrational* ones. See *supra* Part III.A. In either case, it is the act of law violation, and not the motivation for, or hindsight justification of, the act, that mandates liability if actual damages result. It is also safe to presume that illegal acts by directors are done knowingly. If directors fail to inform themselves of all material facts, namely legality, their decisionmaking process would likely breach the duty of care. The "knowingly" presumption would not apply, however, when directors rely in good faith on experts' opinions regarding legality of the act. See *supra* Part III.B.

presumptions of the business judgment rule should not apply to allegedly illegal acts. It also concludes that a plaintiff should be required to prove the illegality of the act, actual damages to the corporation that outweigh related corporate gains, and causation.

*A. The Business Judgment Rule Does Not Apply
to Knowing Violations of Law*

The first issue to consider when examining potential liability for corporate directors is the applicability of the business judgment rule. Under Delaware law, the business judgment rule creates a presumption that "in making a business decision the directors of a corporation acted on an informed basis, in good faith, and in the honest belief that the action taken was in the best interests of the company."⁷¹ This presumption "can be rebutted if the plaintiff shows that the directors breached their fiduciary duty of care or of loyalty or acted in bad faith."⁷² Thus, a showing of illegality by the plaintiff—alone—should rebut the presumptions of the business judgment rule.⁷³ Intentional violations of law, even if fully informed and believed to be in the best interests of the corporation, should therefore not be entitled to business judgment rule protection.⁷⁴

⁷¹Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984).

⁷²*In re Walt Disney Co. Derivative Litig.*, 906 A.2d 27, 52 (Del. 2006); *see also* Brehm v. Eisner, 746 A.2d 244, 264 n.66 (Del. 2000).

[D]irectors' decisions will be respected by courts unless the directors are interested or lack independence relative to the decision, do not act in good faith, act in a manner that cannot be attributed to a rational business purpose or reach their decision by a grossly negligent process that includes the failure to consider all material facts reasonably available.

Brehm, 746 A.2d at 264 n.66.

⁷³Samuel Arsht noted in 1979:

Bad faith may preclude the application of the business judgment defense where directors knowingly violate a statute or comparable expression of public policy, even if such a violation is undertaken in the corporation's best interests. The defense may prevail where directors' actions motivated by the corporate welfare are not clearly contrary to law when taken. Where illegality is clear, however, the courts will not give such conduct by directors the benefit of a presumption against liability. Such benefit would contravene the spirit of statutes governing indemnification of directors, which explicitly preclude indemnification for any criminal action unless the director "had no reasonable cause to believe that his conduct was unlawful."

S. Samuel Arsht, *The Business Judgment Rule Revisited*, 8 HOFSTRA L. REV. 93, 129-30 (1979) (internal citations omitted).

⁷⁴*See* Bainbridge, *supra* note 2 ("The business judgment rule will not insulate from judicial review decisions tainted by fraud or illegality.") (citing Shlensky v. Wrigley, 237 N.E.2d 776, 778 (Ill. App. 1968)); *see also* Miller, 507 F.2d at 762 (stating that "the business judgment rule cannot insulate the defendant directors from liability if they did in fact breach [the applicable statute]");

B. *Proving Illegality, Damages, and Causation*

A plaintiff who alleges that directors caused a corporation to act illegally should have the initial burden at trial of proving a prima facie case. In the lawbreaking context, a prima facie case would include proof that the act was illegal, proof of damages, and proof of causation. Once a plaintiff establishes a prima facie case, the burden should then shift to the directors to rebut the presumption of bad faith, attempt to disprove damages, or show that the benefits derived from the act outweigh the damages. This would require a departure from traditional Delaware jurisprudence involving fiduciary duty liability. For example, in *Disney*, the Delaware Supreme Court stated that once the business judgment rule's presumptions are rebutted, "the burden then shifts to the director defendants to demonstrate that the challenged act or transaction was entirely fair to the corporation and its shareholders."⁷⁵ Entire fairness, however, in the context of reviewing knowing violations of law, is probably not the most suitable standard. "Fair price" cannot be measured objectively because there is no price or basis for comparison. Illegal conduct is most certainly "unfair dealing." The entire fairness standard is also inadequate to measure damages because it would place the burden of proof on the defendant-directors to disprove that which the plaintiff may not have fully proved, i.e., the actual amount of harm. The following parts take a closer look at what could be considered the plaintiff's initial burden—proving illegality, damages, and causation.

1. Illegality

To succeed in a derivative claim alleging intentional violation of law, the plaintiff should first be required to prove that the directors acted illegally. The *Miller* court "stated that the plaintiffs could not recover on the corporation's behalf without 'prov[ing] the elements of the statutory violation as part of their proof of breach of fiduciary duty.'"⁷⁶ Because shareholder derivative suits are civil in nature, the plaintiff's burden of proving illegality should be satisfied by meeting the preponderance of the evidence standard. Requiring shareholder-plaintiffs to prove each element of the alleged illegal act by a higher standard, such as clear and convincing evidence or beyond a reasonable doubt, is likely inappropriate, and "*Miller* does not suggest . . . that

Charles Hansen, *The Duty of Care, the Business Judgment Rule, and the American Law Institute Corporate Governance Project*, 48 BUS. LAW. 1355, 1367 (1993) ("Board action that is illegal will not be protected by the business judgment rule.")

⁷⁵*Disney*, 906 A.2d at 52. "The concept of [entire] fairness has two basic aspects: fair dealing and fair price." *Weinberger v. UOP, Inc.*, 457 A.2d 701, 711 (Del. 1983).

⁷⁶*Ryan*, *supra* note 69, at 451 (quoting *Miller*, 507 F.2d at 764).

derivative plaintiffs would be required to prove the underlying violation by more than a preponderance of the evidence."⁷⁷ If the directors are tried criminally prior to a derivative suit, criminal convictions should be dispositive of illegality, criminal acquittal should not presume legality, and plea bargains to lesser charges should not bar a finding of illegality.⁷⁸ The Delaware Court of Chancery, based on the evidence presented, would make the determination regarding illegality.

2. Damages

In addition to proving illegality, directors should not be liable for a corporation's illegal act unless actual damages are proved. "It is almost axiomatic in civil suits that a remedy will not be provided unless the party seeking judicial relief shows that it, or those it represents, suffered (or will suffer) injury or harm caused by the defendant's conduct."⁷⁹ There are several difficulties, however, in applying traditional Delaware principles concerning damages to directors' intentional violations of law. While traditional remedies for a breach of the duty of loyalty—which is how intentional violations of law would be pleaded if they were considered bad faith—are equitable and monetary in nature,⁸⁰ the typical judicial remedy for a breach of the duty of loyalty is to "strip" away any financial benefit from a self-dealing director.⁸¹ However, in the context of disinterested law violation, defendant-directors are

⁷⁷*See id.* Ryan noted:

There are no significant due process issues raised by permitting civil derivative plaintiffs a lesser burden of persuasion. Derivative suit civil liability damages are not the same as criminal penalties, which may include loss of liberties; nor are the civil derivative plaintiff and the criminal prosecutor possessed of relatively equal resources.

Id. at 451 n.152. As a corollary, consider the Uniform Probate Code's preponderance of the evidence standard for proving homicide where a plaintiff attempts to prohibit a slayer's recovery of estate assets in the will probate context. UNIF. PROBATE CODE § 2-803(g) (1990).

In most jurisdictions, preponderance of the evidence prevails as the standard of proof applicable in the following civil actions that impute crimes: libel or slander actions where the defense alleges that the plaintiff committed the crime; actions on insurance policies where the defense is arson or theft; [and] wrongful death actions

Leigh Ann MacKenzie, Note, *Civil RICO: Prior Criminal Conviction and Burden of Proof*, 60 NOTRE DAME L. REV. 566, 584 (1985).

⁷⁸*See, e.g.*, UNIF. PROBATE CODE § 2-803(g) & cmt. (1990).

⁷⁹Ryan, *supra* note 69, at 452.

⁸⁰*See* ATR-Kim Eng Fin. Corp. v. Araneta, No. 489-N, 2006 Del. Ch. LEXIS 215, at *79 n.127 (Del. Ch. Dec. 21, 2006) (citing Weinberger v. UOP, Inc., 457 A.2d 701, 715 (Del. 1983)).

⁸¹*See* Stephen Bainbridge, *Good Faith in Delaware After Stone v. Ritter*, PROFESSOR BAINBRIDGE.COM (Jan. 3, 2007), http://www.professorbainbridge.com/2007/01/good_faith_in_d.html.

unlikely to gain personally from their act. Other than preliminarily enjoining future illegal acts or removing directors from the board, injunctive relief offers little or no remedy in these circumstances. Thus, knowing violations of law and other "acts in bad faith presumably give rise to monetary liability."⁸² If this presumption is correct, the next issue is how to determine the proper amount of monetary liability.⁸³ There appear to be three possibilities for imposing monetary damages: per se damages, actual damages notwithstanding any gains, and actual damages offset by any gains. This part briefly discusses each possibility, and concludes that the third option—what has been coined the "New York net loss rule"—is best.

First, courts could impose nominal, per se damages on directors even without proof of loss to the corporation.⁸⁴ Proponents of this approach could argue that illegal acts, even if lucrative and not prosecuted, create instability and distrust of the corporation by investors, thereby indirectly harming shareholder value. In other words, a corporation could be inherently damaged by an illegal act, regardless of its consequences. Professor Rapp states that "illegal conduct, unlike merely risky conduct, could have lasting reputational effects for corporations, resulting in far greater losses and perhaps rendering the market for the security illiquid."⁸⁵ This is likely because "[d]irectors who engage in illegal behavior show an especially high tolerance for risk: they are simply betting that their corporations will not be discovered or prosecuted successfully, rather than betting on whether one investment will be more profitable than another."⁸⁶ Even if this is true, actual future damages are speculative at best. Also, the Delaware Supreme Court has shied away from the imposition of per se damages against directors who breach a duty.⁸⁷

Second, courts could impose liability on corporate directors in the amount of proven damages without regard to any related gains. This approach

⁸²*Id.*

⁸³See Arsht, *supra* note 73, at 130. Arsht noted that in the absence of the business judgment defense, directors are liable to the corporation for losses sustained by the corporation because of knowingly illegal conduct. It is a closer question, and one on which the courts appear divided, as to whether directors may claim a setoff against such liability by establishing that the corporation received benefits from the illegal conduct in question.

Id.

⁸⁴This would be akin to the Delaware Supreme Court's language in *Tri-Star*: "In Delaware existing law and policy have evolved into a virtual *per se* rule of damages for breach of the fiduciary duty of disclosure." *In re Tri-Star Pictures, Inc. Litig.*, 634 A.2d 319, 333 (Del. 1993). That language, however, was later limited to only the narrow facts of the *Tri-Star* case, thereby effectively rejecting the application of per se nominal damages for breaches of the duty of disclosure. See *Loudon v. Archer-Daniels-Midland Co.*, 700 A.2d 135, 142, 147 (Del. 1997).

⁸⁵Rapp, *supra* note 7, at 121.

⁸⁶*Id.*

⁸⁷See *Loudon*, 700 A.2d at 146-47.

would parallel the Delaware Supreme Court's holding in *Cede v. Technicolor*, which suggested that under entire fairness review, either as a result of a breach of the duty of loyalty or of care, a plaintiff could recover damages without regard to any resulting benefits from the directors' action.⁸⁸ The ALI similarly "raises the possibility that fiduciaries may be liable to the corporation for illegal corporate activities even when the corporation has made a profit from the illegality."⁸⁹ This standard of damages, however, would produce unfair results: "Recovery for profitable deviance could mean a windfall to the corporation, which would be able to recover from fiduciaries for profitable misconduct while keeping the profits originally obtained from the illegal activities."⁹⁰

Third, Delaware courts could follow the "New York net loss rule."⁹¹ In *Miller*, discussed above, the "court held that under New York law, the plaintiff could not state a cause of action simply by alleging breach of a federal statute without also alleging that the breach caused independent damage to the corporation."⁹² Under the net loss rule,

[t]o sue a company's directors for damages resulting from illegal acts (typically a decline in share price resulting from imminent governmental punishment), a shareholder would need to establish that the loss in share price resulting from the illegal act

⁸⁸*Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 367 (Del. 1993) ("Under *Weinberger's* entire fairness standard of review, a party may have a legally cognizable injury *regardless of whether the tender offer and cash-out price is greater than the stock's fair value . . .*") (emphasis added).

⁸⁹Ryan, *supra* note 69, at 424.

⁹⁰*Id.* (noting that "more accurately, fiduciary liability for profitable illegal acts could be a windfall to the plaintiffs' corporate bar, which is the engine that drives shareholder litigation"); *see also* Bainbridge, *supra* note 2 ("In most cases, the bulk of any monetary benefits go to the plaintiffs' lawyers rather than the corporation or its shareholders.").

⁹¹*See* Beveridge, *supra* note 5, at 743. One commentator has claimed that Delaware adopted New York's net loss rule in *Citron v. Merritt-Chapman & Scott Corp.*, 407 A.2d 1040, 1045 (Del. 1979). Rapp, *supra* note 7, at 109 n.41. This assertion is doubtful. The Delaware Supreme Court in *Citron* concluded that the complaint was premised on the argument that the directors and officers should forfeit compensation because "they were convicted of crimes which prevented them from the performance of duty" to the corporation. *Citron*, 407 A.2d at 1044. Further, it was not alleged that the corporation, itself, had violated the law. *Id.* at 1043-44. Even assuming that the illegal acts complained of in *Citron* could be attributed to the corporation rather than the directors and officers in their individual capacities, the Delaware Supreme Court left open the question of whether actual damage to the corporation was required to impose liability. *Id.* at 1045 ("Even if one adopts the more expansive view of liability . . . and holds that dereliction of duty can result in [liability] notwithstanding the lack of actual harm to the corporation, the question of [liability] must still be governed by the circumstances in each particular case.").

⁹²Beveridge, *supra* note 5, at 743 (citing *Miller v. AT&T*, 507 F.2d 759, 763 n.5 (3d Cir. 1974)).

outweighs the gain in share price resulting from the increased sales or profits the illegal act produced.⁹³

The net loss rule contradicts the general agency principle that "where an agent has profited from a breach of his fiduciary duty, injury to the principal is not required for recovery."⁹⁴ But in the context of law violation, absent allegations of self-dealing, directors are unlikely to profit personally from their decision to violate the law. Therefore, the net loss rule strikes a fair balance between traditional agency principles, Delaware's approach to damages concerning breach of fiduciary duty, and the actual damages requirement of traditional tort law.⁹⁵

Requiring proof of actual damages also strikes a fair public policy compromise. Courts want to deter, or at least not encourage, law violation and they want to promote lawful acts. Thus, directors should be liable for any actual damages resulting from their bad faith conduct.⁹⁶ But shareholders, or a corporation itself, should not be permitted to profit from the corporation's illegal acts. If plaintiffs are not required to prove actual damages that exceed related gains, they would receive the benefit of corporate profits resulting from the illegal act *and* they would receive damages from the directors who maximized their wealth.⁹⁷ Under the net loss rule, even if there is no net loss, directors are not free from sanction for knowing and intentional violations of law. If a shareholder-plaintiff could not prove actual damages that exceed related gains, directors would still face the full range of possible criminal

⁹³Rapp, *supra* note 7, at 103. In the Microsoft example, above in Part I, a shareholder who enjoyed the run-up in the value of Microsoft common stock that resulted from Bill Gates's aggressive and evidently illegal industrial strategy should not now be able to sue to recover the decline in share value resulting from the federal district court's holding that the strategy violated the Sherman Act.

Id. In this context, "courts should have the authority to decide in a particular case whether or not a corporation has suffered damages as a result of an illegal course of conduct." Beveridge, *supra* note 5, at 745.

⁹⁴Beveridge, *supra* note 5, at 744-45 (citing RESTATEMENT (SECOND) OF AGENCY § 389 cmt. c (1958)).

⁹⁵Beveridge notes that ALI's *Principles of Corporate Governance* proposes three changes to the net loss rule: (1) prohibit "the court from offsetting losses from one transaction against profits from other identical but separate transactions," (2) allow "the court to refuse to offset profits that it finds contrary to public policy," and (3) place "on the defendant the burden of proving profits." Beveridge, *supra* note 5, at 745 (citing ALI, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 7.18(c) cmt. e (1992)). Under the scheme proposed in this article, the third proposal would be adopted because the defendant-directors would have the opportunity to disprove actual damages or show that damages have been "setoff" by profits.

⁹⁶*Miller v. AT&T*, 507 F.2d 759, 762 (3d Cir. 1974) (stating that "directors must be restrained from engaging in activities which are against public policy").

⁹⁷*See* Bainbridge, *supra* note 2 (referring to this possible outcome as "double-dipping" by shareholders).

penalties.⁹⁸ The result, then, is not that directors walk away unscathed; it means only that criminal prosecutors, not shareholders, are the proper individuals to enable and encourage a court to impose sanctions. Therefore, the net loss rule's actual damages requirement best serves the interests of the public and provides the most equitable result for both shareholders and directors.

3. Causation

In addition to proving actual damages that exceed related corporate gains, plaintiff-shareholders should be required to prove causation between the directors' illegal act and the corporate harm. However, "in *Technicolor*, the Delaware Supreme Court held that causation was not an element of the duty of care claim."⁹⁹ The Delaware Supreme Court in *Technicolor* stated, "The Chancellor's restatement of the rule—to require [the plaintiff] to prove a proximate cause relationship between the [director-defendants'] presumed breach of [their] duty of care and the shareholder's resultant loss—is contrary to well-established Delaware precedent"¹⁰⁰ But, as Professor Bainbridge notes, the Chancellor's causation requirement in *Technicolor* was drawn from *Barnes v. Andrews*,¹⁰¹ "the leading authority for the well-accepted proposition that 'the undoubted negligence of directors may not result in liability if the plaintiff cannot show that the negligence proximately caused damages to the corporation.'"¹⁰² Assuming that a general causation requirement for damages is well established, notwithstanding *Technicolor*, the requirement should apply to intentional violations of law. Although *Stone* made clear that the duty to act in good faith is a subset of the duty of loyalty, which compels the entire fairness standard of review, perhaps the Delaware Supreme Court would not be averse to creating a more tort-like "duty-breach-causation-damages" test for allegations of intentional law violation. This is logical because director-defendants are unlikely to have gained personally from disinterested decisions to violate the law. Additionally, causation should not be assumed, given the multitude of market forces affecting share value. Therefore, it is reasonable and fair to require shareholder-plaintiffs to prove that directors' illegal acts were the cause in fact of damages suffered by the corporation.

Recently, the Delaware Supreme Court, in a parenthetical, quoted the following observation by the Delaware Court of Chancery regarding good

⁹⁸See *supra* Part II.B.

⁹⁹Bainbridge, *supra* note 81.

¹⁰⁰*Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 367 (Del. 1993).

¹⁰¹298 F. 614 (S.D.N.Y. 1924).

¹⁰²Bainbridge, *supra* note 81 (quoting ROBERT C. CLARK, CORPORATE LAW 126 (1986)).

faith, causation, and damages: "[T]he utility of the duty of good faith 'may rest in its constant reminder . . . that, regardless of his motive, a director who consciously disregards his duties to the corporation and its stockholders may suffer a personal judgment for monetary damages for any harm he *causes*,' even if for a reason 'other than personal pecuniary interest.'"¹⁰³ This language arguably endorses the "actual damages" requirement of the New York net loss rule and rejects *Technicolor's* holding that a plaintiff need not show causation in order to receive damages, at least in the context of bad faith conduct.

V. CONCLUSION

Until its risks outweigh any possible rewards, law violation may continue to be viewed by corporate directors as a rational means of maximizing shareholder wealth. But, in addition to the threat of criminal punishment, shareholders have the opportunity, or perhaps the responsibility, to enforce the social norm of lawful behavior through derivative litigation. Numerous constraints from both inside and outside the corporate enterprise impose a duty upon directors to obey the law. Knowing violations of law, therefore, should create a presumption of bad faith under Delaware's fiduciary duty principles, even though they should not per se be deemed to breach the directors' duty of care. Shareholder-plaintiffs who can prove that directors acted illegally (without reasonably relying on the good faith advice of legal counsel) and caused damages to the corporation that exceed related gains should be entitled to monetary relief on behalf of the corporation from the director-defendants. Shareholders, through their police power, can hold directors accountable for illegal acts that might otherwise go unpunished and possibly deter future illegal conduct.

¹⁰³*In re* Walt Disney Co. Derivative Litig., 906 A.2d 27, 67 n.111 (Del. 2006) (quoting Nagy v. Bistricher, 770 A.2d 43, 48 n.2 (Del. Ch. 2000)) (emphasis added).