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DELAWARE'S "EXPANDING DUTY OF LOYALTY" AND ILLEGAL CONDUCT: A STEP TOWARDS CORPORATE SOCIAL RESPONSIBILITY

David Rosenberg*

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INTRODUCTION

For decades, commentators and students of American business have accepted the basic premise that corporate leaders should make decisions that they reasonably believe to be "in the best interests of the corporation, with a view towards maximizing corporate profit and shareholder gain" and not to achieve any other social good.1 The structure of

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1. Melvin A. Eisenberg, The Duty of Good Faith in Corporate Law, 31 DEL. J. CORP. LAW 1, 5 (2006). Many commentators have taken this to mean that the duty of the directors is to maximize profits. For the definitive statement of this view, see Milton Friedman, The Social Responsibility of Business is to Increase Its Profits, N.Y. TIMES, Sept. 13, 1970, § 6 (Magazine), at 33. While the profit-
our corporate law and governance reflects this outlook and provides a number of market-based and legal checks on the behavior of directors and managers by shareholders. Mindful of these incentives and the possible penalties for failure, corporate leaders, to varying degrees, dedicate themselves to taking action that benefits shareholders by pursuing a profitable bottom line with little regard to how they achieve it. Although recent events suggest otherwise, this system has worked reasonably well to create long periods of growth, dividends and value for investors.²

Proponents of the shareholder wealth or profit-maximization view of the corporation argue that managers should act in shareholders' best interests rather than in the interests of other stakeholders.³ Under this model, managers pursue outcomes that are designed to generate the greatest long-term profits for the corporation without regard to the consequences to those outside the corporation. To the extent that corporate law successfully regulates the behavior of directors and managers, it does so largely by imposing fiduciary duties that prevent them from putting their own interests before those of the shareholders. Noticeably, corporate law says little about the duties owed by directors and managers to entities outside the corporation itself.⁴ This Article proposes that recent developments in Delaware corporate fiduciary law suggest that directors owe a duty of loyalty to stakeholders outside the corporation itself and that this might be a first step towards judicial recognition of a duty of corporate social responsibility.

³ Id.
⁴ Of course, other areas of law such as taxation, labor, employment and environmental law have a profound influence on the ways a corporation's conduct affects outside stakeholders.
I. THE BACKGROUND: DELAWARE'S EXPANDING DUTY OF LOYALTY

The fiduciary duties of corporate directors have a long and often confusing history, especially in the courts of Delaware, the country's primary source for corporate law. While directors' fiduciary obligations were traditionally divided into the separate duties of care, loyalty, and sometimes good faith, recent decisions in the Delaware courts expanded the duty of loyalty to encompass all breaches of fiduciary duty, including actionable bad faith and actionable breaches of the duty of care. Under current law, the duty of loyalty prohibits not only self-interested transactions but also knowing breaches of the duty of care, and, importantly, actions that are illegal even where they are intended to benefit the corporation and maximize profits.

While corporate law does a relatively good job of addressing the interests of the shareholders through the imposition of fiduciary duties, it does little to encourage corporate leaders to act with any sense of "social responsibility." Indeed, a corporate board that ignores negative consequences to communities, the economy and the environment, might well still be acting with absolute devotion to its fiduciary duties to the shareholders. A director will only be liable to shareholders if he makes a decision that is plainly based on self-enrichment rather than profitability, or if he knowingly breaches his duty of care or deliberately approves illegal behavior. If, however, he makes a decision

7. Strine et al., supra note 5, at 653.
8. The term "corporate social responsibility" can mean a lot of things. As one commentator has noted, "t]he debate over corporate social responsibility is often vague or unrealistic or both." Larry Ribstein, Accountability and Responsibility in Corporate Governance, 81 NOTRE DAME L. REV. 1431, 1432 (2006). For the purposes of this Article, "corporate social responsibility" will refer to acts through which corporations deliberately choose to benefit (or to not harm) stakeholders other than shareholders in ways that adversely affect the bottom line. In this Article "stakeholders" will refer to anyone affected by the actions of a corporation other than the shareholders themselves, among them employees, consumers, communities, governments, the environment and society's desire for law and order.
that benefits the shareholders but devastates the interests of other stakeholders, corporate law provides no obvious sanction. Such a decision might be unethical or immoral according to a system of beliefs that does not view profits or shareholder welfare as superior to other values, but it will likely not be a breach of fiduciary duty unless the decision actually violates some law—an environmental regulation for example—that arises outside of the realm of corporate governance. Given the focus on the rights of shareholders in corporate law, the most direct remedy for the social ills produced by such behavior is for the legislature to pass (and effectively enforce) regulatory laws that would provide penalties powerful enough to cause corporate leaders to avoid such costly breaches.

Through the business judgment rule, corporate law provides directors with broad discretion to run and oversee companies, as long as they believe they are acting in “the best interests of the company.” This rule insulates directors from liability for good faith decisions that fail to accomplish the goal of benefitting the corporation and gives them broad discretion to run companies as they see fit. The rule plainly exists within a broader framework that is designed to create the greatest profits for shareholders in a number of ways. First of all, talented and experienced business people would be less willing to become directors of corporations if they feared liability for decisions that do not result in profits, and shareholder welfare is likely maximized by instituting rules that guarantee that the best possible personnel will take on positions of leadership. Second, as an empirical matter, allowing directors to take risks without fear of liability encourages the kind of risk-taking that has contributed to

10. For example, a corporation might choose to dispose of its waste in the cheapest possible legal manner. Such a decision might well cause great harm to a local community although it is also in the best interests of the shareholders.

11. When any actor decides to take illegal action, it takes into account both the penalty and the likelihood of getting caught. A. Mitchell Polinsky & Steven Shavell, Enforcement Costs and the Optimal Magnitude and Probability of Fines, 35 J.L. & ECON. 133, 134 (1992). As with any lawbreakers, corporations will not be penalized for every law they violate because regulators cannot possibly be expected to detect every violation.


13. Id.
America's unrivalled history as a source of progress and innovation.\textsuperscript{14} Indeed, two of the most prominent proponents of the business judgment rule's broad protections have stated that "investors' wealth would be lower if managers' decisions were routinely subjected to strict judicial review."\textsuperscript{15}

From the point of view of shareholders, the business judgment rule seems to work well enough. If it did not, investors would avoid purchasing corporate equities and the stock market would collapse even further than it already has. From the perspective of other stakeholders, however, the picture is mixed. Focused on the best interests of the corporation and mindful of the limited scope of their fiduciary duties, directors have frequently ignored or even trampled on the interests of stakeholders.\textsuperscript{16} It is unnecessary to list the ways conduct that benefits shareholders can harm other members of the community without resulting in any legal sanction against the corporation. Neither the law nor the marketplace has provided effective incentives to change this reality.

In light of recent developments in Delaware corporate fiduciary law, this issue takes on further complexity when corporate directors choose to take action that breaks the law. Legal scholars have long noted that, without the enforcement of sufficiently harsh regulatory laws, directors might rationally choose to break the law in order to create maximum profits.\textsuperscript{17} It might well make sense from the point of view of profits for a corporation to violate an environmental


\textsuperscript{15} Easterbrook & Fischel, \textit{supra} note 2, at 93; \textit{see also} Gagliardi \textit{v.} Trifood Int'l, 683 A.2d 1049, 1053 (Del. Ch. 1996) (stating that a weaker business judgment rule "[w]ould be very destructive of shareholder welfare in the long-term").

\textsuperscript{16} On the other hand, because the business judgment rule must necessarily provide the directors with a great deal of discretion, taking into account the interests of other stakeholders, possibly at the expense of shareholders, is not necessarily a breach of fiduciary duty. Ribstein, \textit{supra} note 8, at 1433; \textit{see e.g.}, the beloved case of Shlensky \textit{v.} Wrigley, 237 N.E.2d 776 (Ill. App. Ct. 1968). The court rejected the claim that directors of a baseball team breached fiduciary duties when making a decision that took into account interests of the community. \textit{Id.} Corporate philanthropy or altruism is certainly protected from review in most cases by the business judgment rule.

\textsuperscript{17} \textit{See, e.g.}, Norwood P. Beveridge, \textit{Does the Corporate Director Have a Duty to Always Obey the Law?}, 45 DEPAUL L. REV. 729, 730–31 (1996).
regulation where the potential penalty (taking into account the likelihood of non-enforcement) is less than the expected savings or increase in earnings. A director accused of misconduct for authorizing such an action might point out (accurately) that she chose that course out of devotion and loyalty to the interests of the corporation and its shareholders. She has directed the corporation to break the law, but it is not clear how she has breached her fiduciary duties to the shareholders.

In the wake of the Delaware Supreme Court's 2006 decision in *Stone v. Ritter*, the duty of loyalty emerged as the dominant expression of a director's fiduciary obligation to a corporation and its shareholders. Any act made in bad faith is now also considered an act of disloyalty. No longer confined merely to the requirement that a director must act in the corporation's best interests rather than his own, the duty of loyalty also covers such acts as knowing breaches of the duty of care. That is to say, a director acts disloyally if he does not believe that his actions are in the best interests of the corporation, either because they were designed to benefit the director himself or because he knew that he has not taken care to evaluate them. The application of the duty of disloyalty to classic duty of care cases makes sense because, as two commentators have noted, by knowingly breaching the duty of care a director is "taking for herself something which should otherwise be the corporation's: her attention and diligence."

Although traditionally considered an act made in bad faith, a profit-maximizing decision to break the law does not fit neatly into any definition of disloyalty because the act

23. See, e.g., Eisenberg, *supra* note 1, at 38 ("Trying to squeeze such [illegal] conduct into the duty of loyalty is like trying to squeeze the foot of Cinderella's stepsister into Cinderella's slipper—an enterprise equally painful and fruitless."); see also Stephen M. Bainbridge et al., *The Convergence of Good Faith and Oversight*, 55 UCLA L. Rev. 559, 593 (2008) ("The point is only that fiduciary obligation and the duty to act lawfully make a bad fit."); Strine et al., *supra* note 5, at 634 (noting that application of Stone's definition of loyalty will be hardest in situations in which "directors act without an apparent selfish..."
does not really constitute taking something that should be the
 corporation's. Like many calculated risks taken in good
 faith, the decision is intended only to help the corporation's
 bottom line. Far from necessarily being disloyal, approving
 an illegal act designed to help the corporation could (with a
 little imagination) be viewed as an act of selflessness by the
 directors, because they are risking their own reputations and
 risking the possibility of personal liability. Further, since the
 usual remedy for breach of fiduciary duty is a shareholder
 derivative lawsuit, in order to bring a worthwhile action for
 disloyalty, plaintiffs would have to allege that the breach
 resulted in real demonstrable damage to a party to whom a
 duty is owed (usually the shareholders or the corporation
 itself)—and this might not be the case. Nonetheless, the
 same courts that have emphasized the centrality of loyalty
 continue to regard approval of profit-motivated illegal activity
 as a breach of a director's fiduciary duty.

 In an earlier Chancery Court opinion upon which the
 Delaware Supreme Court relied in Stone, Vice Chancellor
 Strine referred (mostly joking it appears) to the idea of a
 fiduciary duty of “legal fidelity” which could be invoked when
 a corporate director causes “the corporation to violate the
 positive laws it is obliged to obey.” Strine rejects the need
 for such a duty because, he rightly says, legal fidelity “is
 already a subsidiary element of the fundamental duty of
 loyalty.” Nonetheless, in emphasizing that approval of
 illegal activity is disloyalty, Strine has left unanswered the
 question of how damages should be imposed for such a
 breach. In order to adequately sanction illegal conduct

 interest to injure the corporation” (emphasis added). Even if we regard
 approval of illegal activity as inherently injurious to the corporation, it still is a
 stretch to define it as “selfish.” Other conceptions of the notion of loyalty might
 make it a better fit however. See, e.g., Andrew S. Gold, The New Concept of
 Loyalty in Corporate Law, 43 U.C. Davis L. Rev. 457, 489 (2009) (proposing that
 loyalty can also mean being “true”).

 24. See Hill & McDonnell, supra note 6, at 1795.

 (“Delaware law has long been clear on this rather obvious notion: that it is
 utterly inconsistent with one's duty of fidelity to the corporation to consciously
 cause the corporation to act unlawfully. The knowing use of illegal means to
 pursue profit for the corporation is director misconduct.”).


 27. Id.
designed to maximize the corporation's profits, Delaware law must approach the imposition of damages in a manner that takes into account the harm that such conduct does to stakeholders outside the corporation. Enforcement of the duty of loyalty in this way requires a rejection of the profit-maximization vision of directors' obligations, and necessarily imposes a morality-based duty of loyalty to outside stakeholders. By acknowledging a duty towards such stakeholders, enforcement of the duty of loyalty as it applies to illegal conduct might be a first step towards a broader duty of social responsibility in corporate law.

II. THE LAW'S APPROACH TO ILLEGAL CORPORATE CONDUCT

Although the precise definition of directors' fiduciary duties has long remained unclear, there has always been virtually universal agreement in the courts and by most scholars that approval of illegal activity constitutes a breach—even where such activity would result in a net-gain for the corporation. Indeed, even in Milton Friedman's well-known justification of the shareholder wealth-maximization model, he indicates that business people who relentlessly pursue profit must still "conform[] to the basic rules of the society, both those embodied in law and those embodied in ethical custom." Among judges especially, the idea that the successful pursuit of profits justifies the deliberate violation of law is preposterous. A 1909 New York case involved the payment of "hush money" by an amusement park that enabled the park to stay open on Sundays in violation of a law protecting the Sunday Sabbath. It appears that the corporation paid the bribe because it believed that the increased profits it could earn from opening on Sundays exceeded the price of the bribe and the potential penalties that might follow. The court

28. Many scholars (but apparently few courts) have embraced the notion of "law-as-price" which views a corporation's decision to break the law as a "rational choice." See Cynthia A. Williams, Corporate Compliance With the Law in the Era of Efficiency, 76 N.C. L. Rev. 1265, 1286–87 (1998).

29. Eisenberg, supra note 1, at 31–32.

30. Friedman, supra note 1, at 33 (emphasis added); see also Bainbridge et al., supra note 23, at 593.


32. See id. at 344.
said that such an illegal payment could not be excused on the
grounds that it was “made for the supposed interest of the
corporation”\(^{33}\) emphasizing that the payment was an ultra
vires act,\(^{34}\) an illegal act and “one bad in morals.”\(^{35}\) As
Patrick J. Ryan points out, the court does not analyze the
case in terms of breach of fiduciary duty and does not suggest
that those who authorized the bribe received any personal
benefit that would trigger the duty of loyalty as it was then
understood.\(^{36}\) Ryan also notes that, while the court was
concerned with the ultra vires nature of the bribe, it
“unequivocally regards outright law violations as worse than
ultra vires acts.”\(^{37}\) Indeed, the court rejects the possibility
that the expenditure might have benefitted the corporation,
simply stating that the funds had been “wasted . . . for the
purposes of corrupting public morals.”\(^{38}\) Exhibiting a
refreshingly old-fashioned sense of right and wrong, the judge
ordered the defendant to repay the $800 without addressing
whether his actions might have benefitted the corporation in
the long run.\(^{39}\)

Fast forwarding nearly a century, the Delaware Court of
Chancery addressed a similar issue when the managers of a

33. Id. at 345. The court’s use of the phrase “supposed interest” reflects a
skepticism by judges that illegal activity might ever actually benefit the
corporation, empirical evidence notwithstanding. Perhaps this arises from the
natural bias judges have in favor of those who follow the law. But just as it is
disingenuous to argue that corporations should be socially conscious because
such an approach must be good for the corporation in the long run, it is
disingenuous to say that all illegal activity will harm the corporation in the long
run. Under the facts in Roth, it is entirely possible that violating the Sunday
restriction would indeed benefit the corporation even if it faced the appropriate
penalties and bad PR as a result.

34. An ultra vires act is one that goes beyond the purposes of the
corporation as outlined in its certificate of incorporation. BLACK’S LAW
DICTIONARY 791 (4th ed. 1968). Illegal conduct is always ultra vires because
corporate law restricts statements of purpose to lawful acts. Lawrence A.
Cunningham, A New Legal Theory to Test Executive Pay: Contractual

35. Roth, 64 Misc. at 345.

36. 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, 449–50

37. Id. at 450.

38. Roth, 64 Misc. at 346.

39. See id. at 347.
venture capital limited liability company attempted to break into the Brazilian telecommunications market and agreed to the payment of a bribe in order to secure necessary government permits. To Vice Chancellor Strine, it was "obvious" under these facts that the plaintiffs would bring a cause of action for breach of fiduciary duty. Further, it was equally obvious to Strine that "[u]nder Delaware law, 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 profit for the entity."

III. ILLEGAL CORPORATE CONDUCT AFTER STONE V. RITTER

The Delaware Supreme Court decided Stone v. Ritter in November 2006. A few months after that holding’s re-definition of good faith and its emphasis on the duty of loyalty, the Delaware Court of Chancery applied Stone to two cases central to the stock options back-dating scandal. The practice of stock option back-dating is a good example of illegal conduct plainly designed to benefit the corporation in the long run without personally benefitting the officers who approve it. As such, these cases presented facts which would require the plaintiff to apply Stone’s expanded definition of "loyalty" to defendants whose conduct, though possibly in bad faith, did not represent self-dealing or disloyalty in the traditional sense.

In Ryan v. Gifford, a shareholder of Maxim Integrated Products, Inc. sued members of the board and the compensation committee for issuing backdated stock options to the company’s CEO over the course of several years. The compensation committee had the authority under the company’s shareholder-approved stock option plan to grant the CEO stock options at a price “no less than the fair market value of the company’s common stock, measured by the

41. See id. at 131.
42. Id. Note that although this case involved a limited liability company, Strine states his rule broadly enough (he refers to the fiduciary’s "entity") that it can be applied to other fiduciary business relationships including corporations.
44. Ryan v. Gifford, 918 A.2d 341 (Del. Ch. 2007).
publicly traded closing price for Maxim stock on the date of the grant.\textsuperscript{45} The plaintiff alleged that, in fact, on nine occasions, the company issued the options by pricing them according to a date earlier than the true date of the grant because the price of the stock had risen since that earlier date.\textsuperscript{46} The plaintiff claimed that this violated the stock option plan and harmed the company because it received lower payments for the stock when the CEO ultimately exercised his options later.\textsuperscript{47}

The defendants asserted that the plaintiff's claim failed on the grounds that it did not adequately allege a breach of fiduciary duty, and specifically, that there was "no evidence that the defendants acted intentionally, in bad faith, or for personal gain."\textsuperscript{48} Chancellor Chandler rejected the defendants' motion to dismiss. Citing Stone v. Ritter, Chandler noted that the bad faith necessary for a valid breach of fiduciary duty claim may arise "where the fiduciary acts with the intent to violate applicable positive law."\textsuperscript{49} Following Stone's formulation, he concludes that, because these acts are disloyal to the corporation, they are therefore made in bad faith and lie outside the protection of the business judgment rule.\textsuperscript{50} The defendants did not appear to assert, and the opinion does not address, that the back-dating was designed not to benefit those who approved it, but rather to benefit the corporation by providing deserved compensation in this manner as an alternative to some other form of remuneration.

In Desimone v. Barrows,\textsuperscript{51} shareholders brought a derivative lawsuit against the corporation for authorizing an improper grant of stock options to employees.\textsuperscript{52} In this case, the corporation provided stock options that were supposed to be priced on the date of the grant itself.\textsuperscript{53} Instead, in order to benefit the grantees, the corporation altered the option date...
to a day on which the stock price was at its lowest for the quarter.\textsuperscript{54} This practice, while not uncommon, can be illegal for both tax and accounting reasons.\textsuperscript{55} Citing his earlier opinion in \textit{Metro Communications}, Strine again noted the “obvious”:

In short, 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. Although directors have wide authority to take lawful action on behalf of the corporation, they have no authority knowingly to cause the corporation to become a rogue, exposing the corporation to penalties from criminal and civil regulators. Delaware corporate law has long been clear on this rather obvious notion; namely, that it is utterly inconsistent with one’s duty of fidelity to the corporation to consciously cause the corporation to act unlawfully. The knowing use of illegal means to pursue profit for the corporation is director misconduct.\textsuperscript{66}

Strine’s use of the term “disloyal” must be viewed in the light of \textit{Stone v. Ritter}. The directors did not personally gain from the improper back-dating, but they nonetheless acted with disloyalty towards the corporation. In the absence of a freestanding duty of legal fidelity, we have nowhere else to put illegal conduct.

IV. PROTECTING THE “VICTIMS” OF ILLEGAL CORPORATE CONDUCT

Any discussion of profit-maximizing illegal corporate activity must take a look at the law being broken and examine the sanctions it imposes outside the realm of fiduciary duties and corporate governance. Such regulatory

\textsuperscript{54} Id. at 913.
\textsuperscript{55} Jessica Erickson, \textit{Corporate Misconduct and the Perfect Storm of Shareholder Litigation}, 84 NOTRE DAME L. REV. 75, 127 (2008).
\textsuperscript{56} Desimone, 924 A.2d at 934–35 (emphasis added). Writing in his capacity as a scholar, Strine takes his incredulity even further:

To somehow contend that it is loyal to engage in consciously unlawful conduct because the directors believed in good faith that the conduct would be in the best interests of stockholders desiring profits but in bad faith toward society is, well, silly. Most elementary school students can grasp the means limitation central to the corporation’s mission and, therefore, to the duty of loyalty owed to it by those who manage it.

Strine et al., \textit{supra} note 5, at 653.
laws exist to prevent certain kinds of conduct that might hurt various stakeholders. They are designed to achieve this goal by imposing a penalty on those who breach regulations, whether they are corporations, other business entities or individuals. If those penalties are not effective at preventing the harmful activity, then, in a democratic society, the government (through legislation or rulemaking) should strengthen them so that they provide the proper deterrent.

Unfortunately, as in many other areas, the democratic process does not always produce the ideal result. As Melvin Eisenberg has pointed out, a well-crafted environmental regulation might be designed to impose a penalty on a corporation that exceeds the corporation's likely profit gained from a violation; but if such a law is ineffectively enforced, due to a variety of governmental shortcomings, the corporation will have a strong incentive to violate it anyway. Further, as Eisenberg notes, managers themselves are not likely to be personally penalized for approving illegal actions because the corporation itself will be considered the primary wrongdoer. Most importantly, because of well-known failures in the legislative process (the influence of corporate lobbyists and campaign donors foremost among them), the penalties created under law are often simply not adequate to counter the harm done by their breach.

When a corporation breaks a law, it also, by definition, acts beyond the purpose for which it was incorporated. Therefore, it is committing an ultra vires act. The doctrine of ultra vires has faded in importance in recent years because

57. Virginia Harper Ho puts it nicely in a recent article: "It is generally agreed that stakeholder interests matter very much, but are adequately (and best) protected and advanced outside of corporate law by separate bodies of regulation, such as labor, environment, or consumer protection regulations, and by explicit private contracts, which are the proper tools to address social welfare, equity, and distributional concerns." Virginia Harper Ho, "Enlightened Shareholder Value": Corporate Governance Beyond the Shareholder-Stakeholder Divide, 36 J. CORP. L. 59, 72 (2010).

58. See Bainbridge et al., supra note 23, at 593 ("The point is not that corporations should be allowed to break the law. They should not. If a corporation breaks the law, criminal sanctions should follow for the entity or the responsible individuals.").

59. Eisenberg, supra note 1, at 32–33.

60. Id. Fiduciary duties, he notes, provide a necessary disincentive for managers to approve illegal conduct. Id. at 34.
corporations simply include very broad statements of corporate purpose in their certificates of incorporation. They cannot, however, include illegal activity as a legitimate corporate purpose. Kent Greenfield has persuasively argued that shareholders and other potential plaintiffs might be able to protect the interests of other stakeholders by invoking the doctrine of ultra vires and seeking injunctions when corporations act illegally. One of the great benefits of this approach, Greenfield points out, is that it does not require plaintiffs to demonstrate the damages arising from the illegal activity.

It is not clear that shareholders would be any more likely to pursue this avenue rather than some other non-profit-maximizing approach such as electing a board that will deliberately take into account the interests of outside stakeholders. Both penalties under regulatory and criminal law, as well as injunctions for ultra vires actions, are legal deterrents against illegal activity authorized by corporate directors. But acknowledging their effectiveness still does not explain how the law of fiduciary duties should address the harm caused to a corporation by such actions.

Since the law plainly regards approval of illegal activity

63. Id. at 1352. While Vice Chancellor Strine and his co-authors do not emphasize the doctrine of ultra vires, their discussion of the duty of loyalty sounds very similar:

American corporate law embeds law compliance within the very mission of the corporation. Loyalty to the corporation’s obligation as a citizen to attempt in good faith to abide by the law is not incidental to a director’s duties, it is fundamental. We find it dismaying that this point is even arguable. Strine et al., supra note 5, at 653 n.71.

64. Greenfield, supra note 62, at 1354–55. Prof. Brian J.M. Quinn points out that “the courts are pretty clear that illegal acts are ultra vires and when a director causes the corporation to violate the law the director is not acting in the corporation’s best interests and thus violates his/her duty of loyalty to the corporation.” Brian J.M. Quinn, Fiduciary Duties and Illegal Acts, M&A Law Prof Blog, (March 15, 2010), http://lawprofessors.typepad.com/mergers/2010/week11/index.html. But Quinn’s brief discussion does not explain how such acts hurt the corporation or violate the duty of loyalty in either the traditional sense or the post-Stone sense under Delaware law.
as a breach of the fiduciary duty of loyalty, the law must provide a remedy for such a breach. This task is relatively simple with breaches of the traditional duty of loyalty because the disloyal director likely caused measurable damage to the corporation. For example, if a director disloyally votes to award a contract to a company that the director owns stock in, a court can easily assess damages by calculating the price that the corporation overpaid for the service or by calculating the value lost as a result. Similarly, where a director knowingly fails to act with care on behalf of the corporation, a court can usually determine the monetary damages resulting from that lapse.

However, where a director approves illegal activity in order to maximize profits for the corporation, the resulting damages are less obvious. After all, it is entirely possible that an illegal evasion of regulatory law results in increased net profits for the corporation with no measurable long or short term downside.\(^6\) Assuming a court is willing to hold that directors breached their fiduciary duty of loyalty, determining the resulting damages might still be a tricky proposition.

A look at the case law is not very helpful because, in the few opinions available, the illegal conduct almost always involved some kind of improper payment or similar “waste” of funds that is easily identified or calculable.\(^6\)\(^6\) In the oft-cited Roth v. Robertson for example, the court simply ordered the defendant to pay back to the corporation the $800 he used as an illegal bribe.\(^6\)\(^7\) It was not necessary for the court to determine how else that bribe had harmed the corporation in that case. Similarly, in Miller v. AT&T, plaintiff shareholders brought a derivative action against the company for its illegal failure to collect an outstanding debt of $1.5 million owed by the Democratic National Committee.\(^6\)\(^8\) While failure to collect the money might have been a breach of the duty of diligence, the plaintiffs also alleged that it was an illegal campaign contribution in violation of federal corporate

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\(^6\) Ryan, *supra* note 36, at 455.


\(^6\) Roth v. Robertson, 64 Misc. 343, 347 (N.Y. Sup. Ct. 1909).

\(^6\) Miller v. Am. Tel. and Tel. Co., 507 F.2d 759, 761 (3d Cir. 1974).
campaign spending laws.\textsuperscript{69} The court allowed the plaintiffs to bring the suit alleging damages in the amount of that $1.5 million.\textsuperscript{70} The two most recent prominent Delaware cases to address the fiduciary implications of approval of illegal activity were the stock option back-dating cases, \textit{Desimone v. Barrows} and \textit{Ryan v. Gifford}. In those cases, damages could have been easily calculated because the back-dating resulted in less money flowing into the company treasury when the options were exercised at a price lower than they should have been.\textsuperscript{71}

Unfortunately, these examples do not provide much guidance in situations where directors deliberately choose to act illegally in order to benefit the corporation and ostensibly succeed, for example by evading a regulatory restriction. The traditional method for calculating damages from this kind of illegal activity is known as the "net-loss rule."\textsuperscript{72} The rule imposes damages to the extent that a corporation was actually harmed by the illegal actions authorized by the directors. This frequently makes good sense and presents few difficulties for courts when the illegal conduct results in losses to the corporation and the shareholders can establish bad faith on the part of directors.\textsuperscript{73} The relevance of allowing a shareholder derivative lawsuit becomes more complicated, as a number of commentators have pointed out,\textsuperscript{74} where the corporation turned a profit as a result of the illegal activity. Application of the net loss rule in such instances results in no liability, even though the directors plainly acted disloyally (under \textit{Stone}'s definition) to the corporation.\textsuperscript{75}

\textsuperscript{69} Id. at 762.
\textsuperscript{70} See id. at 763.
\textsuperscript{71} But even in these cases, the defendants could have argued that the back-dating caused no damage because it was used as a creative way of compensating the employees. Without the back-dating, the company would likely have had to sweeten the employees' deals by the same amount it would have lost through the back-dating.
\textsuperscript{72} Ryan, supra note 36, at 455.
\textsuperscript{73} Id. ("As a policy matter, there is little point in shielding directors and officers from derivative liability when the business decision's poor outcome derives from knowing illegal conduct.").
\textsuperscript{74} See, e.g., id. at 424; Beveridge, supra note 17, at 743; Thomas A. Uebler, \textit{Shareholder Police Power: Shareholders' Ability to Hold Directors Accountable for Intentional Violations of Law}, 33 DEL. J. CORP. L. 199, 218–19 (2008).
\textsuperscript{75} Ryan sums up the problem nicely:

Obviously, it is possible to make money by violating the law: if the
While virtually all commentators agree that directors breach a fiduciary duty by knowingly allowing illegal conduct, few have seriously proposed a rule that would actually penalize them under corporate law, unless the firm can show precisely what the damages were. Vice Chancellor Strine and his co-authors express dismay at the idea that illegal conduct should not be sanctioned under corporate law, but they limit legal sanctions to situations in which the corporation suffers a “major injury”:

[Unless the corporation has itself suffered a major detriment as a consequence of lawbreaking, the liability threat to directors is miniscule. Where, however, a corporation faces major injury as a result of illegal conduct, we see no reason why corporate fiduciaries should not face responsibility if they knowingly caused or tolerated the illegal conduct.]

It is hard to see how such a view is different from those of the profit-maximization purists who might favor allowing corporate law to ignore illegal activity that improves the bottom line. Indeed, a refusal to penalize profitable-but-bad faith illegality reduces such conduct to the same status as the much less blameworthy self-interested but nonetheless “fair” transactions.

Corporate law wisely allows directors to make decisions that benefit themselves when such decisions also help the corporation. When interested directors vote in favor of self-gains obtained from corporate deviance exceed the sum of all losses attributable to the illegal conduct, it is hard to express in monetary terms just how the corporation has been “damaged” by fiduciary participation in illegality, or by managerial failure to prevent the illegal conduct. On the other hand, restricting derivative recovery to those cases where corporate deviance has resulted in a “net loss” to the corporation would make corporate doctrine appear to tolerate illegal activity if the crime did pay.

Ryan, supra note 36, at 452–53.


77. Strine et al., supra note 5, at 652 n.69; see also Uebler, supra note 74, at 220 (“[T]he 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.”).

78. See Bainbridge et al., supra note 23, at 594.
enriching actions they will not be held liable if a court later
determines that the approved action was “fair” to the
corporation, even if their self-serving behavior rose to the
level of bad faith.\textsuperscript{79} In such a case, it may well be that the
director knowingly abandons her sense of impartiality
because she knows that it will benefit the corporation.\textsuperscript{80} If
the director is able to establish fairness, courts will infer
loyalty (despite self-interest) because the decision was made
in the best interests of the corporation.\textsuperscript{81} This does not offend
our sense of justice because, after all, nobody really got hurt
by the bad faith intentions of the director: the corporation got
as good a deal as it would have gotten absent the self-
interested decision. The bad faith director gets a pass
because, despite his bad faith, the transaction was fair to the
traditional wards of corporate law: the shareholders. The
moralists among us may frown at the director’s behavior, but
we will not venture to sue because we cannot point to any
victims or calculate their damages.

The idea of determining the fairness of a transaction
seems entirely alien to any discussion of illegal corporate
conduct, yet the prevailing rule under corporate law provides
precisely the same result. Applying the “net-loss” rule to
approval of illegal activity by corporate directors seems to
parallel application of the fairness doctrine to disloyal
behavior, yet is totally inappropriate. Under the rule,
directors who approve illegal activity may not be liable for
damages if the illegal activity actually provides a net benefit
to the corporation. This seems akin to suggesting that a
decision to approve unlawful activity (though illegal, disloyal
and immoral) is "fair" to the corporation, and therefore not
actionable, because it helped to maximize profits. At least the

\textsuperscript{79} Strine and his co-authors explain: “Delaware law requires that the
interested party prove that the transaction was entirely fair to the corporation,
in the sense that it was on terms as favorable as could have been achieved in an
arms-length deal subject to market competition.” Strine et al., supra note 5, at
643. There are, of course, valid policy justifications for this rule: a corporation
ought to be able to benefit from directors’ decision to award a company contract
to a certain firm even if that contract will benefit the directors personally if the
decision is \textit{fair} to the corporation.

\textsuperscript{80} Clark W. Furlow, \textit{Good Faith, Fiduciary Duties and the Business

\textsuperscript{81} See id.
result is the same. In cases of either profitable illegal activity or "fair" disloyalty, a director knowingly breaches a fiduciary duty (either acting in his own self-interest or authorizing illegal activity), but incurs no personal liability for that breach under corporate law because the decision did not result in a loss for the corporation.

While making an exception for fairness in the case of self-interested transactions seems right, allowing the same exception for illegal activity makes no sense. The difference, of course, is that the obligation to act within the law is the only fiduciary duty under which the direct victims of the director's disloyalty are outside the corporation itself. Although the victims cannot sue under fiduciary law, they do have a remedy—the one established by the regulation that was violated. It might, for example, impose a civil or criminal penalty against the corporation. Further, it might allow a civil lawsuit by the victims against the corporation or against those who authorized the illegal activity. Corporate law, however, does not seem to provide an adequate remedy for non-shareholder victims of illegal corporate conduct which current law labels "disloyal." The courts are thus faced with the problem of how to enforce a duty (loyalty) where the direct victims of the breach of that duty are not the same as the people to whom that duty was owed.

V. LOYALTY TO WHOM?

For the fiduciary duty of loyalty to include an obligation not to break the law, it must provide some kind of sanction that applies even in cases where the violation did not hurt the company itself. Under the duty of loyalty as formulated by the Delaware courts, shareholders will only recover when they can prove damages. It therefore might seem to make sense to create an independent duty to obey the law, and for the rule to mandate a penalty even where the lawbreaking maximized corporate profits. Bainbridge and other scholars reject the idea of viewing illegal activity as "per se violation of the duty of loyalty" because they believe that it would impose a "significant restriction on the discretionary powers of boards of directors."82 Supporters of creation of such an

82. Bainbridge et al., supra note 23, at 594. They explain: "After all, the
independent duty would likely argue that directors do not have the discretion to choose to break the law. Vice Chancellor Strine, (writing as judge) opines that an independent duty of “legal fidelity” is unnecessary and redundant because it is already covered by the duty of loyalty.83 But he too, (writing as a scholar) seems to support a rule that would not penalize illegal conduct that does not harm the corporation’s bottom line.84 This essentially affirms the idea that profit-maximization is paramount, even if it involves bad faith director-approved illegal activity.

In order to penalize illegal activity under the fiduciary duty of loyalty, we must determine to whom such activity is disloyal and assess damages based on the harm done to them. Interestingly, most discussions that support strict fiduciary duty based sanctions on illegal activity justify their rule by pointing to stakeholders beyond the confines of the corporation itself. Any system of rules that categorizes illegal activity as disloyal must necessarily broaden the sense of a director's duties to include loyalty to something other than the welfare of the corporation. Indeed, to understand loyalty in this context requires an explanation that brings us fairly close to an acceptance of the notion of corporate social responsibility and to a view of corporate law that requires directors to adhere to a sense of moral and ethical justice.

Melvin Eisenberg's approach makes the necessary link between obeying the law and morality. Working within the profit-maximization model,85 Eisenberg rejects the notion that that goal can be achieved through illegal means, because to do so would be immoral and dishonest. He says:

point of the business judgment rule is that shareholders should not be allowed to recover monetary damages simply because the directors made the wrong decision.” Id. at 593. The authors are perhaps confused in their use of the word “wrong.” The business judgment rule protects directors who make decisions that turn out to be wrong in that they did not benefit the company (for example, by choosing to drill for oil where none was subsequently found). Proponents of corporate law sanctions for illegal activity are surely arguing that such actions are “wrong” in the moral sense, even if they appear to accrue benefit to the company.

84. Strine et al., supra note 5, at 652 n.69.
85. Eisenberg asserted that profit-motivated illegal conduct is not a violation of the duty of loyalty. Eisenberg, supra note 1, at 38.
For a complex society to thrive, the bulk of its members must internalize the moral obligation to obey the law. Similarly, given the dominance of organizations in complex societies, such a society could not thrive if individuals believed themselves free of a moral obligation to obey the law when they acted in an organizational rather than personal capacity. Therefore, there is a strong social interest in prohibiting managers from knowingly causing the corporation to disobey the law in search of profits. This objective cannot be achieved solely by criminal and regulatory actions against the corporation.

Note the emphasis on the moral obligations of corporate actors and the negative effect illegal activity would have on the rest of our complex society. Eisenberg later says, “[a] corporate manager who knowingly causes the corporation to violate the law lacks honesty, because he knows that he is acting improperly and is violating generally accepted standards of decency applicable to the conduct of business.” This statement might actually be wrong as a normative matter—many might say that the conduct of business in the United States is typified by deliberate violations of law in pursuit of maximum profits and a notable absence of decency. But the important point is Eisenberg’s reliance on moral traits—among them, honesty and decency—and not merely on obedience to the law. Since the moral deficiencies inherent in illegal behavior do not necessarily damage the stockholders, directors who approve such conduct are violating a duty—can we call it a fiduciary duty?—to someone outside the corporation itself. It is not just that they are breaking a law by, for example, polluting a river, it is that they are also making the continuing success of a complex civil society more difficult by violating a moral obligation.

Other commentators have also pointed out the moral dimension created by the law’s recognition of a fiduciary relationship. Hill and McDonnell suggest, for example, that “fiduciaries are classically supposed to be honest and

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86. Id. at 31–32 (emphasis added).
87. Eisenberg supports this argument with choice quotations from the classic decisions on the issue. For example, in his discussion of Roth v. Robertson, Eisenberg quotes a section in which the judge emphasizes the immorality of the offense and its effect on public policy. Id. at 35.
88. Id. at 38 (emphasis added).
honorable, and simply breaking the law can be seen as running afoul of that characterization." The authors do not make much of this rather speculative notion, but it does echo the more established idea that illegal activity is ultra vires. Establishment of a fiduciary relationship through the issuance or purchase of stock imposes an obligation on the directors not only to adhere to the corporation's statement of purpose (which requires acting within the law) but to behave in the manner a fiduciary is supposed to behave: honestly and honorably towards those both inside and outside the corporation. This takes the notion of "loyalty" beyond the relationship between the director and shareholder, and suggests a duty to society as well.

**CONCLUSION**

Enforcement of a fiduciary duty not to approve illegal activity is an important first step towards diminishing the prevalence of the profit-maximization view of the corporation. Recognizing such action as disloyal is not necessarily inconsistent with Eisenberg's approach that emphasizes the immorality and dishonesty required to approve illegal action. Both ultimately require courts to acknowledge that the directors of corporations owe duties to people and entities outside the corporation itself.

Given the near-universal agreement that directors are not empowered under corporate law to operate corporations in an illegal fashion, Strine is right to reject the idea of creating an independent duty of "legal fidelity." The Delaware courts have already made absolutely clear that approval of illegal activity is an act of disloyalty under the state's fiduciary duty law. Eisenberg and other scholars are rightly troubled though, essentially asking the question:

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90. *See supra* notes 34–35 and accompanying text.
91. Blair and Stout also acknowledge the ethical dimension of the fiduciary relationship, comparing directors to trustees "whose duties are imbued with a similar moral weight." Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 316 (1999). While they do not emphasize duties to those outside the corporation, the authors note the power of "corporate cultural norms of fairness and trust" to influence the behavior of directors. *Id.*
92. *See supra* Part III.
disloyal to whom? The answer lies in Eisenberg’s own formulation: approval of illegal activity is disloyal to the system of *moral obligations* which allows corporations to function in the first place.\textsuperscript{93}

In order for the duty of loyalty to mean anything when applied to illegal activity by corporations, courts must be able to impose damages even if the conduct in fact benefited the company’s bottom line. This requires recognizing interests other than those of the shareholders. But neither the “net loss” rule nor traditional Delaware fiduciary duty law does this. The best solution to this problem is the one proposed by Eisenberg within the context of the broad concept of loyalty favored by the Delaware courts: holding the “disloyal” directors liable for fines imposed on the company without offsetting them by any gains achieved through the illegal conduct.\textsuperscript{94}

Such a reform is possible, but only if courts are willing to depart from their narrow, inward-looking view of the damages arising from a director’s breach of fiduciary duties. Shareholders ought to be able to bring a derivative lawsuit claiming disloyalty by directors who approve illegal conduct regardless of whether the conduct benefitted the corporation’s bottom line. Their complaint must show, not that the conduct hurt the corporation, but that it violated a rule designed to protect stakeholders outside the corporation. By allowing such a lawsuit and by imposing damages that arise from the harm done to outside stakeholders (and ignoring any possible benefit to the corporation), courts will bring Delaware’s powerful notion of loyalty in line with Eisenberg’s vision of the moral corporation as a necessary ingredient of a civil society. The result is a small step away from the profit-maximization standard and towards recognition of corporate social responsibility.

\textsuperscript{93} See Eisenberg, supra note 1, at 31–32.

\textsuperscript{94} See id. at 37. Eisenberg notes that this reflects the rule in Section 7.18(c) of the *Principles of Corporate Governance* “which provides that a manager’s liability arising out of a wrongful transaction may not be offset by gains to the corporation that arose out of the same transaction if the offset would be contrary to public policy.” Id. (emphasis added).