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Delaware's "Expanding Duty of Loyalty" and Illegal Conduct: A Step Towards Corporate Social Responsibility

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I. 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.\(^2\) The structure of 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 the shareholders by pursuing a profitable bottom line with little regard to how they achieve it. Although

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\(^2\) 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 Responsibilities of Business is to Increase Profits, N.Y. Times, Sept. 13, 1970 Section 6 (N.Y. Times Magazine). While the profit-maximization view is now disfavored, this paper will not explore the complexities of this controversy because, for our purposes, the distinction is not vital. The crucial point is that the fiduciary duties of corporate directors focus on the interests (broadly defined) of the shareholders and the corporation itself, not on those of outside stakeholders.
recent events suggest otherwise, this system has worked reasonably well to create long periods of growth, dividends and value for investors.

Proponents of the shareholder wealth or profit-maximization view of the corporation argue that managers should act in the shareholders’ best interests rather than in the interests of other stakeholders. 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 other stakeholders. 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. This article proposes that recent developments in Delaware fiduciary law suggest that corporate 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.

II. Delaware’s Expanding Duty of Loyalty

The fiduciary duties of corporate directors have had 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 duties of care and loyalty (and sometimes good faith), recent decisions in the Delaware courts distilled them down into what amounts to a single, fairly expansive duty: loyalty. Under current law, the duty of loyalty prohibits not only self-interested transactions but also

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3 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.

knowing breaches of the duty of care, and, importantly, actions that are illegal even
where those actions 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 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 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.

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5 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,
For the purposes of this article, it 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.
Through the business judgment rule, corporate law provides directors with broad discretion to run and oversee companies as they see fit as long as they believe they are acting in “the best interest 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 indeed designed to create the greatest profits for shareholders. 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; shareholder welfare is quite 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 America’s unrivalled history as a source of progress and innovation. 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.”

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

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frequently ignored or even trampled on the interests of stakeholders. And it is not necessary here to list the ways that 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 sufficient 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, in the absence of the enforcement of sufficiently harsh regulatory law, directors might rationally choose to break the law in order to create maximum profits. It might well make sense from the point of view of profits for a corporation to violate an environmental 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 how has she 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

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9 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, supra note 5, at 1433. See e.g., the beloved case of Shlensky v. Wrigley, 237 N.E.2d 776 (Ill. App. 1968) (court rejected claim that directors of baseball team had breached fiduciary duties when making decision that took into account interests of the community). Corporate philanthropy or altruism is certainly protected from review in most cases by the business judgment rule.

10 See, e.g., Norwood P. Beveridge, “Does the Corporate Director Have a Duty to Always Obey the Law?” 45 DePaul L. Rev. 729 (1996).
act of disloyalty. No longer confined merely to the requirement that a director must act in the corporation’s best interests and not 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 does not really constitute taking something that should be the corporation’s. Like many good faith calculated risks, 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 are opening themselves up to 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

11 Hill and McDonnell, supra note 1.
12 Rosenberg, supra note 7, at 230.
13 Hill and McDonnell, supra note 1, at 1795.
14 See, e.g., Eisenberg, supra note 2, 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 Bainbridge, Star Lopez and Benjamin Oklan, “The Convergence of Good Faith and Oversight,” 55 U.C.L.A. 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 4, at 634 (noting that application of Stone’s definition of loyalty will be hardest in situations in which “directors act without an apparent selfish interest to injure the corporation.”) (italics 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.”
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.\textsuperscript{15}

In an earlier Chancery Court opinion upon which the Delaware Supreme Court
relied in \textit{Stone}, Chancellor Strine referred (mostly joking it appears) to the idea of a
fiduciary duty of “legal fidelity” which could be invoked where a corporate director
causes “the corporation to violate the positive laws it is obliged to obey.”\textsuperscript{16} 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.”\textsuperscript{17} 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
designed to maximize the corporation’s profits, Delaware law must approach the
imposition of damages in a way 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

\textsuperscript{15} See, e.g., Desimone v. Barrows, 924 A.2d 908, 934 (Del. Ch. 2007) (“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.”).
\textsuperscript{16} Guttman v. Huang, 823 A.2d 492, 506 (Del. Ch. 2003).
\textsuperscript{17} \textit{Id.}
applies to illegal conduct might be a first step towards a broader duty of social
responsibility in corporate law.

III. 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\(^\text{18}\) 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 \textit{embodied in law} and those embodied in ethical custom.”\(^\text{19}\)

Among judges especially, the idea that the successful pursuit of profits justifies
deliberate violation of law is preposterous. A 1909 New York case on the subject
involved the payment of “hush money” by an amusement park so that the park could stay
open on Sundays in violation of a law protecting the Sunday Sabbath.\(^\text{20}\) 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 said that such an illegal payment could not be excused on the grounds
that it was “made for the supposed interest of the corporation”\(^\text{21}\) emphasizing that the

\(^{18}\text{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, 1286-1295 (1998).}

\(^{19}\text{Friedman, \textit{supra} note 2 (italics added). See also, Bainbridge et al., \textit{supra} note 14, at 593.}

\(^{20}\text{Roth v. Robertson, 64 Misc. 343 (1909).}

\(^{21}\text{Roth, 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 good for the corporation in the long run, it is disingenuous to say that all illegal activity will harm the corporation in the}
payment was an ultra vires act (i.e. “foreign to the objects of the corporation”), an illegal act and “one bad in morals.”\textsuperscript{22} 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 in a way that would trigger the duty of loyalty as it was then understood.\textsuperscript{23} 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.”\textsuperscript{24} 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.”\textsuperscript{25} Exhibiting a refreshingly old-fashioned sense of right and wrong, the judge ordered the defendant to repay the $800 without really considering whether his actions might have benefitted the corporation in the long run.

Fast forwarding nearly a century, the Delaware Court of Chancery addressed a similar issue when the managers of a venture capital limited liability company attempting to break into the Brazilian telecommunications market agreed to the payment of a bribe in order to secure necessary government permits.\textsuperscript{26} To 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

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\textsuperscript{22} \textit{Roth} at 345


\textsuperscript{24} \textit{Id.} at 450.

\textsuperscript{25} \textit{Roth}, at 346.

\textsuperscript{26} Metro Communication Corp v. Advanced Mobilecomm Technologies Inc., 854 A.2d 121 (Del. Ch. 2004).
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.”

The Delaware Supreme Court decided *Stone v. Ritter* in November 2006. A few months after that holding’s redefinition 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 backdating scandal. The practice of stock option backdating 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 publicly traded closing price for Maxim stock on the date of the grant.” 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. The plaintiff claimed that this violated the stock option plan and that it harmed the company by

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27 *MetroCommunications* at 131. 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.


29 *Ryan*, at 347.
causing it to receive lower payments for the stock when the CEO ultimately exercised his options later on. 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.”

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.”

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. The defendants did not appear to assert, and the opinion does not address, that the backdating 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, shareholders brought a derivative lawsuit against the corporation for authorizing an improper grant of stock options to employees. In this case, the corporation provided stock options that were supposed to be priced on the date of the grant itself. 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. This practice, while not uncommon, is illegal for both tax and accounting reasons. Citing his earlier opinion in 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.

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30 Ryan at 348.
31 Ryan at 356.
32 Ryan at 357.
33 Ryan at 357.
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.  

Strine’s use of the term “disloyal” must be viewed in the light of Stone v. Ritter. The directors did not personally gain from the improper back-dating, but they have 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 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

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34 Desimone at 934-935 (2007) (italics 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. supra note 4, at 653.  
35 Virginia Harper Ho puts it nicely in a recent article, “Enlightened Shareholder Value: Corporate Governance Beyond the Shareholder-Stakeholder Divide, 36 J. Corp. L. __, at __: “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.”
business entities or individuals.\textsuperscript{36} If those penalties are not effective in 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 ideal lets us down. Non-enforcement of course is a problem. 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.\textsuperscript{37} 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.\textsuperscript{38} 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 is also, by definition, acting beyond the purpose for which it was incorporated. That is, it is committing an ultra vires act. The doctrine of ultra vires has faded in importance in recent years because 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 others might be

\textsuperscript{36} See, Bainbridge et al., \textit{supra} note 14, 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.”).

\textsuperscript{37} Eisenberg, \textit{supra} note 2, at 32.

\textsuperscript{38} Id. Fiduciary duties, he notes, provide a necessary disincentive for managers to approve illegal conduct. \textit{Id}. 
able to protect the interests of other stakeholders by invoking the doctrine of ultra vires and seeking injunctions when corporations act illegally.\(^{39}\) 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.\(^{40}\) 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 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 in those cases the disloyal director likely caused measurable damage to the corporation. 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

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\(^{39}\) 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, 1352 (2001). While 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 4, at FN 71.

\(^{40}\) Greenfield, supra note 39, at 1354. In a March 15, 2010 blog post, Prof. Brian JM Quinn of “M&A Law Prof Blog” 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.” 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.
fails to act with care on behalf of the corporation, a court can usually determine the monetary damages resulting from that lapse.

But 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.\textsuperscript{41} Assuming a court is willing to hold that directors breached their fiduciary duty of loyalty, how can it determine the resulting damages?

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.\textsuperscript{42} In the oft-cited \textit{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.\textsuperscript{43} It was not necessary there for the court to determine how else that bribe had harmed the corporation. Similarly, in \textit{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.\textsuperscript{44} 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 campaign spending laws. The court allowed

\textsuperscript{41} Ryan, \textit{supra} note 23, at 455.
\textsuperscript{42} As one commentator has noted, disgorgement is the traditional remedy for breach of loyalty. John A. Humbach, “Director Liability for Corporate Crimes: Lawyers as Safe Haven,” (unpublished, available at http://digitalcommons. Pace.edu/lawfaculty/650/)
\textsuperscript{43} \textit{Roth} at 347.
\textsuperscript{44} \textit{Miller} at 761.
the plaintiffs to bring the suit alleging damages in the amount of that $1.5 million.\textsuperscript{45} 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{46}

But 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{47} 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 little difficulties for courts where the illegal conduct results in losses to the corporation and the shareholders can establish bad faith on the part of directors.\textsuperscript{48} The relevance of allowing a shareholder derivative lawsuit becomes more complicated, as a number of commentators have pointed out\textsuperscript{49}, 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

\textsuperscript{45} \textit{Miller} at 763.
\textsuperscript{46} 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{47} \textit{Ryan}, supra note 23, at 455.
\textsuperscript{48} \textit{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.”).
although the directors plainly acted disloyally (under Stone’s definition) to the corporation.\textsuperscript{50}

While virtually all\textsuperscript{51} 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. 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”:

\begin{quote}
\ldots 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.\textsuperscript{52}
\end{quote}

It is hard to see how such a view is different from those of the profit-maximization purists\textsuperscript{53} 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. Where interested directors vote in favor of

\textsuperscript{50} Ryan sums up the problem nicely:

\begin{quote}
Obviously, it is possible to make money by violating the law: if the 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.
\end{quote}

\textsuperscript{51} With the possible exception of Stephen Bainbridge.

\textsuperscript{52} Strine et al., supra note 4, at FN. 69. See also, Uebler, supra note 49, at 221 (“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”).

\textsuperscript{53} See Bainbridge et al., supra note 14, at 594.
self-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{54} As Clark Furlow explains, 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{55} 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{56} 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 his bad faith was fair to the traditional wards of corporate law, the shareholders. The moralists among us may still 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 fairness 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,

\textsuperscript{54} 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., \textit{supra} note 4, 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{56} Id.
disloyal and immoral) is “fair” to the corporation because it helped to maximize profits. At least the 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 where 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 et al. reject the idea of viewing illegal activity a “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” although supporters would argue that directors do not have the discretion to choose to break the law. 57 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. 58 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. 59 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. And any system of rules that categorizes illegal activity as disloyal must necessarily broaden our 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

57 Bainbridge et al., supra note 14, at 594. They explain: “After all, the 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.

58 Guttman at 506.

59 Strine et al., supra note 4, at FN 69.
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, Eisenberg rejects the notion that that goal can be achieved through illegal means because to do so would be immoral and dishonest. He says:

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

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60 And asserting that profit-motivated illegal conduct is not a violation of the duty of loyalty. Eisenberg, supra note 2, at 38.
61 Id., at 31-32.
62 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.
63 Id. at 38. Emphasis added.
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 honorable, and simply breaking the law can be seen as running afoul of that characterization.”64 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.65 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 way a fiduciary is supposed to behave: honestly and honorably towards those both inside and outside the corporation.66 This takes the notion of “loyalty” beyond the relationship between the director and shareholder and suggests a duty to society as well.

VI. 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

64 Hill and McDonnell, supra note 1, at FN 85.
65 See text and accompanying notes 39-40.
66 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.” Blair and 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.
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, Chancellor 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 in an act of disloyalty under the state’s fiduciary duty law. Eisenberg and others are rightly troubled though, essentially asking the question – 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.67

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.68 This is possible, but only if courts are willing to depart from their narrow, inward-looking view of the damages arising from a

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67 Eisenberg, supra note 2, at 31.
68 Id. 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).
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.