

## What Independent Directors Should Expect from Inside Directors: *Smith v. Van Gorkom* as a Guide to Intra-Firm Governance

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### I. EXPLORING THE RELATIONSHIP BETWEEN INSIDE AND OUTSIDE DIRECTORS

*Smith v. Van Gorkom*<sup>1</sup> is the watershed case in which the board of a public company was held liable for breach of its fiduciary duty of care. The board of Trans Union Corporation (Trans Union) approved the company's sale to Jay Pritzker after a twenty-minute oral presentation by Chief Executive Officer Jerome Van Gorkom. The board spent only two hours considering Pritzker's offer before approving it. The directors received no notice or information before the meeting that its purpose was to approve the company's sale to Pritzker, nor did they receive anything in writing describing the proposed deal. No crisis or emergency warranted their hurried approval of the sale.

When I traveled by plane from New York to Washburn University School of Law to participate in a symposium commemorating the twentieth anniversary of *Smith v. Van Gorkom*, I spent the entire time chatting with the passenger seated next to me. During our conversation, he confided that he had served for years as a senior officer of a public company and that he now sat on the board of a closely held corporation. Eventually he asked me about the purpose of my trip. "I'm presenting a paper at a symposium about the fiduciary duty of care," I told him. At this point, I decided to ask him about any experience he may have had with this topic. "What kinds of discussions have you had with your attorneys about the duty of care?" I asked. He stared blankly for a few moments, so I asked, "Have you ever had a discussion about the duty of care with your attorneys, fellow board members, or officers?" Finally he answered, sharing his experience as director of a small company. "We've made several loans to employees when they were in need. We care about our employees. Yes, the duty of care is important for us."

Fiduciary duty does not seem to be part of the discourse that takes place among corporate directors, executives, officers, managers, and the lawyers who advise them. It may be that only law professors talk about fiduciary duty,<sup>2</sup> and this may be especially true as far as the

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1. 488 A.2d 858 (Del. 1985).

2. One of the authors of the casebook I use for my Business Organizations class said the following: "[U]nlike fiduciary duties, securities regulation is something lawyers talk about. Al-

duty of care is concerned. Not all law professors, however, talk about the duty of care. At least one does not teach *Van Gorkom*.<sup>3</sup>

Even if the case is not part of explicit corporate governance discourse, *Van Gorkom*'s laudable legacy is that it may have made boards more vigilant, diligent, and careful. Evidence exists that the decision has inspired careful board decision-making.<sup>4</sup> One of the most salient aspects of the *Van Gorkom* legacy, however, is found in the legislative response to the case.<sup>5</sup> Potential personal liability for directorial breaches of the duty of care under *Van Gorkom* inspired the Delaware legislature to enact section 102(b)(7) of the Delaware Code Annotated.<sup>6</sup> This section allows Delaware corporations to eliminate or reduce directorial liability for duty-of-care breaches. The Delaware legislature justified its enactment of 102(b)(7) by pointing to the significant increase in the cost of directors and officers insurance in *Van Gorkom*'s aftermath. When the smart, experienced, and seasoned directors of Trans Union were held personally liable for duty-of-care breaches, directors throughout Delaware wanted to protect themselves. This sharp increase in demand for insurance resulted in a dramatic increase in its cost.

Most states have followed Delaware's example and have enacted statutes that allow corporations to reduce or eliminate the prospect of personal liability of their directors for duty-of-care breaches. Because of this legislative response to the *Van Gorkom* holding, the case has bequeathed a surprising legacy. Instead of invigorating and clarifying the fiduciary duty of care, the *Van Gorkom* holding initiated a severe erosion of the duty.

The erosion of the significance of the duty of care continued in the case law under various interpretations of the business judgment rule. One approach to the business judgment rule is seen in what has been called the abstention doctrine. This approach to the business judgment rule "creates a presumption against judicial review of duty of care claims. The court will abstain from reviewing the substantive merits of the directors' conduct unless the plaintiff can rebut the busi-

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though fiduciary duties structure the way lawyers organize transactions and firms, they are not an explicit part of law-firm discussions. Lawyers do not tell summer associates, I do fiduciary duty work . . ." WILLIAM A. KLEIN ET AL., *TEACHER'S MANUAL FOR BUSINESS ASSOCIATIONS, CASES AND MATERIALS ON AGENCY, PARTNERSHIPS, AND CORPORATIONS* 254 (2003).

3. See Lawrence A. Hamermesh, *Why I Do Not Teach Van Gorkom*, 34 GA. L. REV. 477 (2000).

4. See EDWARD BRODSKY & M. PATRICIA ADAMSKI, *LAW OF CORPORATE OFFICERS AND DIRECTORS: RIGHTS, DUTIES AND LIABILITIES* § 2:14, at 2-50 (2005).

5. See *id.* § 2:14, at 2-58 to -59. *Van Gorkom* has inspired courts to closely examine the conduct of directors responding to takeover attempts in order to determine whether they satisfied their duty of care. *Id.*

6. DEL. CODE ANN. tit. 8, § 102(b)(7) (2001).

ness judgment rule by showing” that directorial decision-making was tainted by fraud, illegality, or conflict of interest.<sup>7</sup>

This judicial deference under the business judgment rule and legislative enactments allowing firms to limit or eliminate directors’ personal liability for care breaches have eroded the importance of the duty of care. This means that shareholders will find it difficult to hold boards accountable for duty-of-care breaches. Shareholders are not able to effectively monitor board conduct in this context.<sup>8</sup>

Does the duty of care become irrelevant without a way for shareholders to effectively hold boards accountable for its breach? Because boards owe fiduciary duties to shareholders only, any lessening of shareholders’ ability to hold boards accountable for care breaches dramatically reduces the duty’s significance. No other corporate constituent can monitor the board’s satisfaction of its care obligations. If shareholders are less able to monitor the board’s care obligations, they must rely on each director’s sense of professionalism and personal responsibility to conduct the board’s business in a way that adheres to judicial and legislative pronouncements that describe the content of the duty of care.

As shareholders lose their ability to hold boards accountable for breaches of the duty of care, the duty remains relevant as an aspirational model for director’s conduct when used as a guide for intra-firm governance. In this article, I focus on internal governance of the corporation rather than judicial review of board decisions and processes. The duty of care, as articulated in case law, is a normative guide. It

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7. STEPHEN M. BAINBRIDGE, CORPORATION LAW AND ECONOMICS 243 (2002).

Because of the erosion of the significance of the duty of care under statutes such as Delaware’s 102(b)(7) and the abstention approach to the business judgment rule, duty-of-care cases are rarely litigated. Since there are relatively few duty-of-care cases, there is not much by way of judicial guidance and insight into the processes, omissions, and failures that will constitute duty-of-care breaches. Moreover, the few recent duty-of-care cases that have been litigated, including *Van Gorkom*, focus on the director’s duty of care rather than the duty of care that corporate officers owe.

In spite of this erosion of the duty of care’s significance, the prospect of an officer being named a defendant in a case alleging a duty-of-care breach remains significant for two reasons. Statutes such as Delaware’s 102(b)(7) allow corporations to eliminate or reduce a director’s personal liability for care breaches and do not apply to corporate officers. Senior executives may be named as defendants in cases seeking to impose personal liability for care breaches. It is likely, however, that officers will recover the costs incurred in such litigation, but indemnification is only likely and is far from certain. Second, even if officers suffer no monetary losses from care breaches, they will certainly suffer reputational harm.

8. Legislative enactments and judicial interpretation, which eroded the significance of the duty of care, are not the only reasons why derivative litigation is an inadequate way to hold boards accountable. Settlement of shareholder derivative suits primarily benefit plaintiffs’ attorneys who earn generous fees. Settlement terms rarely make boards function better. “[S]ettlement recoveries in shareholder litigation may provide only for payment of attorneys’ fees. Critics of the shareholder suit assert that most of the suits are frivolous and that the plaintiff’s bar is the true beneficiary of the litigation.” Roberta Romano, *The Shareholder Suit: Litigation Without Foundation?*, in FOUNDATIONS OF CORPORATE LAW 170, 171 (1993). According to Romano, “[t]he data support the conclusion that shareholder litigation is a weak, if not ineffective, instrument of corporate governance” because “[t]here is little evidence of specific deterrence . . . .” *Id.* at 179.

can provide a way for independent directors to evaluate the inside directors who serve with them. The duty of care offers potential guidance to inside directors so that they provide independent board members with the information they need to satisfy *their* fiduciary duties.

In Part I of this article, I appraise the ability of individual directors to motivate those who serve with them on the board to exercise care. I focus on the relationship between independent and inside directors. I discuss horizontal monitoring and suggest that outside directors make clear their expectation that inside directors satisfy care obligations. In Part II, I continue to explore the relationship between inside and independent directors and discuss a closely related aspect of the horizontal monitoring described in Part I. I consider the ability of independent directors to monitor and assess the conduct of inside directors when those insiders act as corporate officers.

Van Gorkom was an inside director.<sup>9</sup> He was the chairman of Trans Union's board of directors, but he was also the company's chief executive officer (CEO). Four other insiders served on Trans Union's board: Bruce Chelberg was chief operating officer; William Browder was Senior Vice-President-Law; Thomas O'Boyle was Senior Vice-President-Administration; and Sidney Bonser. *Van Gorkom* reveals nothing about the duty of care that inside directors owe with respect to their conduct as the company's senior managers. What about the nature of the duty of care owed by Van Gorkom, Chelberg, Browder, O'Boyle, and Bonser as officers of Trans Union who also served on the company's board?<sup>10</sup> And more relevant to the thesis of this article, what should the outside directors have expected from them as inside directors?

The court in *Van Gorkom* did not distinguish between inside and outside directors. This was not an oversight on the court's part. The board's attorneys presented a defense for the nine directors as a whole. Insiders and outsiders shared an identical defense. Counsel for the board argued that the "ultimate issue in [the] case [was] whether or not nine honest, experienced businessmen should be sub-

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9. The term "insiders" in this article refers to directors who not only serve on the board, but also are employed by the company. Independent directors are not employed by the corporation on whose board they serve. The other measures of director independence include whether the director was employed by the company in the years immediately preceding his service on the board and whether a director is controlled by company insiders or has some other important employment, economic, or familial relationship with any of the company's senior executives. See BAINBRIDGE, *supra* note 7, at 219; see also Michael Bradley & Cindy A. Schipani, *The Relevance of the Duty of Care Standard in Corporate Governance*, 75 IOWA L. REV. 1, 21 (1989). "An outside director is generally defined as a director who is otherwise unaffiliated with and independent of the corporation." Bradley & Schipani, *supra*. I will also use the term "outsiders" to refer to independent directors.

10. For a discussion of the managerial duty of care see Cheryl L. Wade, *Corporate Governance Failures and the Managerial Duty of Care*, 76 ST. JOHN'S L. REV. 767 (2002).

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ject to damages in a case where—.” Counsel was interrupted by Justice Andrew G.T. Moore II who asked whether there was “a distinction between [the chief operating officer] and Van Gorkom vis-à-vis the other defendants.” “No, sir,” was counsel’s reply. “None whatsoever?” asked Justice Moore. Counsel replied, “I think not.”<sup>11</sup>

Almost two decades later, Professor Stephen Bainbridge wrote the following:

Consistent with our analysis of the board as a collegial body, [section 8.30 of the Model Business Corporations Act] stresses evaluation of the board’s collective decision-making process. Defaults by a single director are irrelevant to the judicial evaluation. Instead, courts are to focus on the conduct of the board as a whole.<sup>12</sup>

The failure to distinguish between inside and outside directors may not be a problem as far as judicial review is concerned when shareholders seek to hold boards accountable for care breaches.<sup>13</sup> The distinction is significant, however, when it comes to examining the relationships among directors. Bainbridge describes the concept of horizontal monitoring that takes place in groups such as boards:

[T]he internal dynamics of group governance constrain self-dealing and shirking by individual team members and, perhaps, even by the group as a whole . . . . [M]utual monitoring and peer pressure provide a coercive backstop for a set of interpersonal relationships . . . . [B]ecause people care about how they are perceived by those close to them, communal life provides a cloud of witnesses whose good opinion we value. We hesitate to disappoint those people and thus strive to comport ourselves in accordance with communal norms. *Effort norms will thus tend to discourage board members from simply going through the motions, but instead to devote greater cognitive effort to their tasks.*<sup>14</sup>

Directors who “simply [go] through the motions” breach their duty of care.<sup>15</sup> Horizontal monitoring, which inspires directors to do more than simply go through the motions to earn the respect of the other board members, encourages satisfaction of their fiduciary duty of care. Mutual cooperation among directors, the expectation of each director that the other board members will do their jobs, and peer oversight make boards more effective.

This article focuses on the potential for independent board members to monitor insiders. Case law describing the duty of care will help them to do so. It has the potential to helpfully govern what outsiders should expect for inside directors. The duty of care, therefore, becomes relevant as a way to define the expectations that

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11. Smith v. Van Gorkom, 488 A.2d 858, 899 (Del. 1985) (Christie, J., dissenting).

12. BAINBRIDGE, *supra* note 7, at 298 n.46.

13. Shareholders “are the corporate constituency perhaps least able to meaningfully monitor management behavior.” *Id.* at 212.

14. *Id.* at 212-13 (emphasis added).

15. *Id.* at 213.

outsiders should have for inside board members. The duty of care can become an explicit part of what outsiders ask of insiders. Inside directors are likely to fulfill this expectation because of the dynamic of horizontal monitoring that Bainbridge describes.<sup>16</sup>

The traditional focus on a board's collective decision-making obscures the notion of individual accountability and responsibility. The unitary approach to review board action ignores the conduct and procedures undertaken by individual board members who participate in the decision-making process not only as directors but also as officers. Here are the relevant questions. What did the inside directors do during the time between Van Gorkom and Pritzker's first meeting in September at which they discussed Pritzker's acquisition of Trans Union and the shareholder vote in February that approved the merger/acquisition? What acts did Van Gorkom undertake in his role as board member? What conduct is attributable to Van Gorkom's role as an officer of Trans Union? Similar questions should be posed about the acts or omissions of the other four inside directors. What did they do or fail to do as inside directors? What did they do or fail to do as officers?

The court in *Van Gorkom* made clear that the type of uninformed decision-making that occurred during the board's first meeting approving the Pritzker acquisition could be cured.<sup>17</sup> One of the most significant things the Trans Union inside directors could have done would have been to attempt to cure the uninformed decision initially made by the board. The board unsuccessfully attempted such a cure at its October 8 meeting.

Understanding what independent directors should expect from inside directors as far as care obligations are concerned requires analysis of and reflection on the care obligations of corporate officers in general.<sup>18</sup> This topic has received minimal attention in both the academic literature and the discourse among corporate actors. In an earlier article, I distinguished the amount of care that officers owe from the amount of care directors owe based on the officers' knowledge of the corporation that is superior to the knowledge of outside directors who are not involved in the company's day-to-day affairs. I

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16. If, however, horizontal monitoring fails to inspire insiders to fulfill the expectation of outsiders that inside directors will satisfy care obligations, the expectation is enforceable, even if its enforceability is limited as a result of the duty of care's erosion. The board may bring a direct suit on behalf of the corporation when insiders continue to shirk and breach care obligations. Outside directors may file litigation against insiders seeking to hold them accountable for care breaches. At this point, distinguishing insiders from outsiders becomes relevant for judicial review.

17. *Smith v. Van Gorkom*, 488 A.2d 858, 885 (Del. 1985).

18. Understanding the duty of care that officers owe is imperative because corporate officers provide essential assistance to independent directors that enables the directors to satisfy the duty of care *they* owe shareholders.

concluded that officers owe a greater amount of care than do “outside directors who have far less contact and involvement with the company.”<sup>19</sup> This assertion is consistent with a subsequent Delaware Chancery Court decision stating that “officers and directors with a ‘specialized expertise or knowledge’ can be held to a higher standard than other directors in litigation.”<sup>20</sup>

Robert Magnuson listed the lessons to be learned from *Van Gorkom* as indicated in subsequent decisions when directors were deemed to have satisfied their duties. He did not distinguish between independent and inside directors, but he offered advice on how directors in general can best satisfy their duty of care. His advice required that senior managers assist board members in this endeavor. According to him, decisions in *Van Gorkom*’s aftermath provided “a road map for defendants seeking to avoid a puncturing of the business judgment rule.”<sup>21</sup> His advice included the following admonitions:

Make sure that material information is provided to the directors before critical decisions are made, and make sure the information . . . is documented . . . . If the transaction relates to the sale . . . of a public company, make sure that all relevant information with respect to price is given, including the company’s own view of what the future holds for the corporate business.<sup>22</sup>

These are steps that independent directors could take only with the help of corporate insiders who have the information outsiders need for adequate decision-making. In giving his advice, Magnuson explicitly mentions the duty of senior managers “to come forward with the complete store of facts leading up to the proposed transaction.”<sup>23</sup> This is exactly what *Van Gorkom* failed to do.

The importance of senior executives and officers to independent directors and their ability to satisfy their fiduciary duties is no less significant when the officers or executives serve on the board with outside directors. Because they are also officers, inside directors owe a greater amount of care than do independent board members. That is why the unitary approach to the assessment of board decision-making is wrong—especially when considering the relationship between inside and outside directors. Even if *courts* should consider board conduct as a collective, this should not obscure the need for clarification of the relationship between inside and outside directors and the need for independent board members to let inside directors know what is expected of them.

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19. Wade, *supra* note 10, at 770.

20. Kara Scannell, *Judge Decides Some Directors Are More Liable*, WALL ST. J., Oct. 12, 2004, at C1 (distinguishing officers and directors with special knowledge from their less knowledgeable counterparts).

21. ROGER J. MAGNUSON, 2 SHAREHOLDER LITIGATION § 16:4, at 16-19 (2005).

22. *Id.* § 16:4, at 16-19 to -20.

23. *Id.* § 16:4, at 16-20.

*Van Gorkom* and other duty-of-care cases give independent directors something by which to measure the work of inside directors. The cases can serve as a model for what independent directors should expect from inside directors. This approach allows fiduciary duty to become part of an explicit discussion between independent and inside members of the board.

#### A. *Information Gathering and Sharing*

The flow of information from inside directors to independent directors is the foundation of a robust relationship that enables all board members to satisfy their care obligations.

One of the most common breaks occurs when the CEO doesn't trust the board enough to share information. What kind of CEO waits until the night before the board meeting to dump on the directors a phone-book-size report that includes, buried in a thicket of subclauses and footnotes, the news that earnings are off for the second consecutive quarter? . . . [T]his destructive, dangerous pattern happens all the time. . . . It is impossible for a board to monitor performance and oversee a company if complete, timely information isn't available to the board.<sup>24</sup>

Most commentators recognize the board's duty of inquiry. "It is . . . the responsibility of the board to insist that it receive adequate information. The degree to which this doesn't happen is astonishing."<sup>25</sup> The goal of this article is to provide guidance with respect to the dynamics of a board's request for information. The board's duty of inquiry is meaningless without emphasizing the concomitant duty of insiders to provide complete and accurate information to independent board members about circumstances relevant to extraordinary transactions. Again, this is exactly what *Van Gorkom* failed to do.

Improving the relationship between inside and independent directors, by having independents make it clear that they need complete and accurate information from insiders, enables independents to do a better job for the corporation.<sup>26</sup> One additional distinction should be made in order to clarify the board's duty of inquiry. Not only should outsiders seek information from inside directors, but insiders also owe a duty of inquiry. This duty requires inside directors to seek and gather information from the officers, managers, and employees who are their subordinates. Not all of this information will be transmitted from inside directors to outside board members. Independent direc-

24. Jeffrey A. Sonnenfeld, *What Makes Great Boards Great*, HARV. BUS. REV., Sept. 2002, at 109.

25. *Id.*

26. Three independent members of the United Parcel Service board remarked "how well plugged-in they have felt over the years because the inside members are very candid and well informed." *Id.* at 108. The company was listed near the top of the 2001 *Fortune* magazine list of the most-admired companies. *Id.*

tors are only able to process a certain amount of information. Too much information may cloud judgment.<sup>27</sup> Inside directors must gather material information, synthesize it, and transmit what outsiders need to know. This kind of information gathering, and its transmittal to outsiders, is imperative for outsiders to satisfy their fiduciary duties. I would, however, hesitate to advocate for judicial review of inside directors' decisions to sift through and choose the information that outsiders need. A great amount of discretion is needed to make this type of determination. What outsiders need to know is not an easy determination and may not be easily and definitively resolved.

What is most important is that care obligations become part of the explicit discourse between outside and inside directors. Outsiders should make clear that they expect insiders to install the information-gathering systems to which Chancellor William T. Allen refers in *In re Caremark International Inc. Derivative Litigation*.<sup>28</sup> This is vertical monitoring<sup>29</sup> that requires insiders to install mechanisms that will reveal information about the deep interiors of the corporation.

The hierarchical structure of the corporation will allow for lower-level employees to pass information up to mid-level employees who will pass information up to the various stages of management. Managers will transmit information to officers, and the information should flow from officers to inside directors. The completeness and accuracy of the information must be monitored by inside directors, and there may be times when insiders need to communicate with employees "deep[ ] [with]in the interior of the organization."<sup>30</sup> This is the most efficient way to communicate information because it prevents the decision-makers at various levels from receiving too much information that will cloud their decision-making ability.<sup>31</sup>

The concomitant of the inside director's duty to inquire is the insider's duty to inform independent directors about the information they need to have. This is the most efficient and least costly way to ensure that outsiders have the information they need to satisfy their fiduciary duties.

Efficient flows of information are especially critical to the success of authority-based decisionmaking structures. As a scarce good, however, information is costly to produce and transmit, which has implications for decisionmaking. For effective management, a low cost mechanism must be created to ensure that those with the power to make decisions have the necessary information, which must not be distorted by others' subjective interpretations, but does

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27. BAINBRIDGE, *supra* note 7, at 232.

28. 698 A.2d 959, 970 (Del. Ch. 1996).

29. See BAINBRIDGE, *supra* note 7, at 210-11.

30. *In re Caremark*, 698 A.2d at 968.

31. *Id.* at 970.

not overload the decisionmakers with unnecessary, distracting information.<sup>32</sup>

B. *Accountability of Inside Directors to Independent Directors Rather than Shareholders*

My point in this article is to encourage the accountability of inside directors—not to shareholders through derivative litigation—but to independent members of the board through horizontal monitoring.<sup>33</sup> While it is true that “only collective decisions taken at a meeting of the board at which a quorum is present are binding on the corporation,”<sup>34</sup> understanding and improving board behavior requires an exploration of what independent directors should expect from inside directors. The collective action of the board will suffer without examining the relationship between outsiders and insiders.

The expectation of each director that other board members will do their jobs enables boards to function effectively. “Directors who take their duties seriously, and let their fellow directors know they’re expected to do the same, are the best insurance against a board” that fails to exercise care.<sup>35</sup> More specifically, independent directors should let inside directors know that they expect them to take their duties seriously. Some may be concerned that inside directors’ enhanced accountability to independent directors will destroy the ability of a board to work peacefully toward the consensus needed for board action. Jeffrey Sonnenfeld, however, observed that companies perform better when dissent is encouraged.

[T]he highest performing companies have extremely contentious boards that regard dissent as an obligation and that treat no subject as undiscussable. Directors at these companies scoff at some of the devices more timid companies use to encourage dissent, such as outside directors asking management to leave while they discuss company performance. What’s the point of criticizing management, they ask, if management isn’t there to answer the criticism?<sup>36</sup>

Sonnenfeld observed that even successful boards can benefit from “peer review.”<sup>37</sup> “The peer review can consider the constructive

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32. BAINBRIDGE, *supra* note 7, at 232.

33. This approach does not trigger Bainbridge’s concern about “the proper mix of discretion and accountability.” *Id.* at 207-08.

[T]he power to hold to account is ultimately the power to decide. Managers cannot be made more accountable without undermining their discretionary authority. Establishing the proper mix of discretion and accountability thus emerges as the central corporate governance question . . . . [G]iven the significant virtues of discretion, one ought not lightly interfere with management or the board’s decisionmaking authority in the name of accountability.

*Id.* Under my approach, decision-making remains with the board. There is no shift to another entity to which the decision-maker is ultimately accountable.

34. *Id.* at 214.

35. Sonnenfeld, *supra* note 24, at 113.

36. *Id.* at 111-12.

37. *Id.* at 113.

and less constructive roles *individual directors* play in discussions . . . [including their] *preparedness and availability*.”<sup>38</sup> Sonnenfeld suggests that the nominating or governance committees of the board can best handle this kind of peer review. My suggestion is that to the extent this kind of formal review is performed by a committee, the committee should be composed of independent directors. My suggestion, however, applies not only in the context of a formal mechanism of peer review, but also to the very essence of the relationship between insiders and outsiders. All independent directors, not just committee members charged with conducting a peer review, should make clear their expectations regarding the preparedness and availability of inside directors. Being available and prepared for board meetings is an essential part of the inside director’s duty of care, and the expectation that the duty is to be satisfied should be communicated to insiders by all independent board members.

There are two basic problems that compromise my thesis about the ability of independent directors to monitor inside directors. First, insiders typically nominate independent directors, so they may not be adequate monitors of insiders.<sup>39</sup> This potential for bias on the part of outsiders favoring the insiders who nominated them for board service is significant. There are, however, “many examples . . . of independent directors acting to make major changes, including the replacement of the president or chief executive officer and creation of standards of conduct for the board.”<sup>40</sup>

Second, why is there a need for independent directors to monitor inside directors? The interests of inside directors are likely to be aligned with the interests of shareholders. This is because inside directors receive generous compensation packages for their service as officers, and this typically includes the company’s stock or options.<sup>41</sup> Why would insiders not satisfy their duty of care when their personal financial interests depend on the success of the corporation? Professor Roberta Romano observed that insider ownership makes it more likely that inside directors will satisfy their duty of care.<sup>42</sup> Insider ownership, therefore, is a good substitute for shareholder litigation that seeks to hold boards accountable.<sup>43</sup> Insider’s holdings give them incentive to exercise ordinary care.

Insider interests, however, may not always align with the interests of other shareholders. Van Gorkom’s conduct seemed grossly negli-

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38. *Id.* (emphasis added).

39. See ARTHUR R. PINTO & DOUGLAS M. BRANSON, UNDERSTANDING CORPORATE LAW 119 (1999).

40. *Id.* at 118-19.

41. Romano, *supra* note 8, at 178.

42. *Id.* at 179.

43. *Id.* at 180.

gent in spite of his ownership interest. He was about to retire and may have wanted to dispose of his shares quickly. (There may have been a loyalty problem). His short term interest as a shareholder who wanted to sell quickly was not aligned with the interests of other shareholders. Moreover, Professor Romano made her point about the incentives insiders have to satisfy care obligations because of their holdings before the Enron debacle. Ken Lay, Enron's former CEO and chairman, breached his duty of care. The chair of the special committee appointed to review the conduct of Enron's board wrote the following:

There was a fundamental default of leadership and management. . . . Leadership and management begin at the top, with the CEO, Ken Lay. In this company, leadership and management depended as well on the chief operating officer, Jeffrey Skilling. The board of directors failed in its duty to provide leadership and oversight.<sup>44</sup>

One commentator's analysis of data from a corporate governance website challenged the assumption that directors will exercise greater care if they hold significant amounts of their company's shares. He found that board members' stock ownership did not separate "good boards from bad" boards.<sup>45</sup> "[A]ll board members of the least-admired companies [on *Fortune* magazine's 2001 list] held substantial equity stakes. Not only did all but one of the Enron board members own impressive amounts of equity in the company, but some were still buying as the shares collapsed."<sup>46</sup>

## II. A SECOND DIMENSION OF PEER REVIEW AND THE IMPORTANCE OF ROLE DIFFERENTIATION

### A. *Judicial Deference Under the Business Judgment Rule: Distinguishing Officers from Directors, Role Differentiation, and Other Specifics About the Relationship Between Independent Directors and Inside Board Members*

In Part I of this article, I appraise the ability of individual directors to motivate those who serve with them on the board to exercise care. My focus is on the relationship between independent and inside directors. I suggest that outside directors make clear their expectation that inside directors satisfy care obligations. Cases such as *Van Gorkom*, which speak to duty-of-care issues, offer guidance for this type of intra-firm governance. The decision offers insight into what independent directors should expect from inside directors.

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44. Katie Fairbank & Jim Landers, *Lay Knew Enron Was Hiding Losses*, DALLAS MORNING NEWS, Feb. 5, 2002, at 1A.

45. Sonnenfeld, *supra* note 24, at 107.

46. *Id.*

In this Part II, I continue to explore the relationship between inside and independent directors and will discuss a closely related aspect of the horizontal monitoring described in Part I. Because one of the paramount responsibilities of corporate boards is to monitor officers, I consider the ability of independent directors to monitor and assess the conduct of inside directors when those insiders act as corporate officers.<sup>47</sup> Independent directors should communicate to inside directors that they expect the insiders to fulfill the duty of care they owe not only as board members, but also as officers.

The approach I advocate in this section requires independent directors to determine when insiders are acting in their capacity as directors and when they are acting as officers. I use the term “role differentiation” to describe the practice of distinguishing among the various roles undertaken by a single individual. Distinguishing among the various roles undertaken by a single corporate actor is a difficult task. One of my co-panelists at the Washburn symposium concluded in an earlier article that judicial review is problematic when one person plays more than one role in the corporate context.<sup>48</sup> The law, however, is clear with respect to the roles of officers and directors. Directors deal with extraordinary issues in the corporation’s life. They decide broad policy issues and monitor officers. Officers implement the policies of directors and oversee the company’s day-to-day operations. Given the clarity of the law in this regard, there seems to be no reason why judges cannot determine whether an individual is serving the corporation in her capacity as an officer or director. Corporate actors, when observing various corporate formalities, frequently distinguish among the multiple roles they and others play in the corporate setting. When deciding matters that require them to discern whether corporate formalities are observed, courts understand distinctions among the two or more roles played by actors in the cor-

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47. As agents of the corporation, officers owe fiduciary duties to the corporation rather than to shareholders. See Lyman P.Q. Johnson & David Millon, *Recalling Why Corporate Officers Are Fiduciaries*, 46 WM. & MARY L. REV. 1597, 1644 (2005). It is more than appropriate for independent directors rather than shareholders to monitor insiders’ satisfaction of the care obligations they owe as officers. The board, acting on behalf of the company, is the principal—not an agent. “[W]hen the board acts collectively, it functions as a principal in agency law terms. Unless shareholder approval is required . . . the act of the board is the act of the corporation.” BAINBRIDGE, *supra* note 7, at 235. It is in this capacity that independent board members, acting collectively or as a committee, should review insiders’ conduct and insist on providing complete information.

48. Lawrence A. Hamermesh & A. Gilchrist Sparks III, *Corporate Officers and the Business Judgment Rule: A Reply to Professor Johnson*, 60 BUS. LAW. 865, 874 (2005).

The institutional problem for judicial review in these circumstances is this: [G]iven the typical involvement of both directors and officers, and the typical overlap of roles and communications, it is likely to be fiendishly complex for a court, let alone a jury, to sort out when and where any given defendant is acting (or failing to act) in a distinct capacity as a director or officer.

*Id.*

porate setting. This kind of role differentiation is essential in corporate law.

Two cases provide examples of role differentiation in other corporate law contexts. In *Frigidaire Sales Corp. v. Union Properties, Inc.*,<sup>49</sup> two men avoided personal liability because the Supreme Court of Washington distinguished between their conduct as limited partners of a firm that had breached a contract with the plaintiff, and their conduct as officers, directors, and shareholders of the general partner of the breaching firm. The court relied on the fact that the individual defendants were scrupulous about observing corporate formalities. This sort of clear distinction, however, may not exist when inside directors serve the corporation as officers. It may be more difficult to differentiate between the insider's work as officer and the insider's work as director, but the difficulty should not preclude the necessary distinction.

*Escott v. BarChris Construction Corp.*<sup>50</sup> provides another example of role differentiation. In this case, shareholders of BarChris Construction Corporation sued the company and several individuals for misstatements in the company's registration statement. One of the defendants, Grant, drafted most of the registration statement. Grant was a director and also served as outside counsel for BarChris. The United States District Court for the Southern District of New York differentiated between the two roles Grant fulfilled, making it clear that Grant's liability was based on his performance as a director, not as the company's lawyer.

Courts are able to distinguish among the various roles fulfilled by a single corporate actor. In any event, even if some courts find role differentiation too difficult, this article's focus is not on judicial review, but on peer review.

### B. *Does the Business Judgment Rule Apply to Officers?*

The duty of care that independent directors owe shareholders includes a duty to monitor officers, and this should include monitoring insiders. Under certain circumstances, this fiduciary duty may require independent directors to go after a corporate officer who has breached his or her fiduciary duty.<sup>51</sup> This can be done through direct litigation brought by the board on the corporation's behalf. This course of action avoids the attempt to rely on shareholders' weakened ability to hold managers accountable through derivative litigation.

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49. 562 P.2d 244 (Wash. 1977).

50. 283 F. Supp. 643 (S.D.N.Y. 1968).

51. Cf. Lyman P.Q. Johnson, *Corporate Officers and the Business Judgment Rule*, 60 BUS. LAW. 439, 463-64 (2005).

This also requires an assessment of the appropriateness of judicial review of the conduct and decision-making of corporate officers. And, most relevant to the thesis in this article, it requires consideration of the appropriateness of judicial review of the decisions and conduct of insiders when serving the corporation in their role as officers rather than as directors. In other words, once role differentiation takes place and the insider's conduct and decision-making as a corporate officer is isolated, there is an additional issue to resolve. Does the business judgment rule apply to corporate officers to protect their decisions in the same way it applies to protect the decision-making of directors? Should courts defer to officers' decision-making in the same way they defer to the decisions made by directors?

Courts are split on this issue. Some have held that the business judgment rule applies to both directors and officers.<sup>52</sup> There is, however, the possibility that a court will conclude that the business judgment rule applies only to directors and not officers.<sup>53</sup> Professor Lyman P.Q. Johnson artfully supports the view that the rule should not apply to officers.<sup>54</sup> I agree with Professor Johnson. The better view is that the business judgment rule does not apply to officers. This makes insiders' conduct as officers relevant.

I agree with Professor Johnson that civil liability for officers' care breaches is appropriate, but I think it is unlikely because of the issues discussed in Part I—erosion of the duty of care and difficulties with derivative litigation that prevent shareholders from holding boards accountable. For these reasons, I focus on peer review and horizontal monitoring rather than judicial intervention in Part I. The applicability of the business judgment rule becomes relevant, however, when insiders fail to live up to the expressed expectations of independent directors that inside directors satisfy their fiduciary duties. As Professor Johnson indicates, if the board decides to bring litigation against corporate officers, judicial deference under the business judgment rule for officers is inappropriate. Johnson argues that a court would undermine the board's business judgment and its decision to pursue a claim against a corporate officer for misconduct or nonfeasance if the court were to "broadly shelter a corporate officer's conduct from judicial review . . . using the business judgment rule."<sup>55</sup>

The majority view, however, seems to be that the business judgment rule applies equally to protect both directors and officers.<sup>56</sup>

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52. See *FDIC v. Stahl*, 854 F. Supp. 1565 (S.D. Fla. 1994); *Selcke v. Bove*, 629 N.E.2d 747 (Ill. App. Ct. 1994).

53. See, e.g., *Platt v. Richardson*, No. 88-0144, 1989 WL 159584 (M.D. Pa. June 6, 1989).

54. Johnson, *supra* note 51, at 440.

55. *Id.* at 464.

56. See *Hamermesh & Sparks*, *supra* note 48, at 865.

Professors Lawrence A. Hamermesh and A. Gilchrist Sparks III responded to Professor Johnson, disagreeing with many aspects of his thesis.<sup>57</sup> In spite of their disagreement with several of Johnson's points, Hamermesh and Sparks's "support for applying the business judgment rule to officer conduct is not unlimited. . . . [A]n officer should not ordinarily be protected by the business judgment rule with respect to conduct that contravenes policies or directives established by the board of directors . . . ."<sup>58</sup> This article clarifies the relationship between inside and independent directors, suggesting that independent directors express their expectations to inside directors. These expectations include the provision by inside directors of the information independent directors need to satisfy *their* fiduciary duties. Providing information to outside directors is something that insiders would do in their role as corporate officers. If an inside director fails to comply, that insider contravenes the directives established by the board, and under the approach advocated by Hamermesh and Sparks, the business judgment rule should not protect the insider.

The view that the business judgment rule applies only to protect the decision-making of directors is a minority view. Yet, in the aftermath of glaring care breaches at companies such as Enron and WorldCom, academic criticism of judicial deference to managerial decision-making may lead to closer examination of the business judgment rule's applicability. There are very compelling reasons why the rule should protect only the decision-making of directors and should not apply to officers. Justifications of the rule's applicability to directors' decisions do not apply in the context of managerial decision-making. For example, one frequently articulated justification for the rule is that potential liability for care breaches will lead to overly cautious decision-making on the part of directors. Without the protection of the business judgment rule, directors will not take the kinds of risks that will achieve the corporate goal of maximizing shareholder profit. While this argument makes some sense when applied to directors, officers' decision-making processes are qualitatively different. The problem of unconsidered risk-taking on the part of corporate officers is far less excusable than the sometimes hastily taken risks by boards that may be pressed for time and that typically meet only once a month.

One court expressed concern that without the protection of the business judgment rule, directors would not take risks because the risks would lead to liability without a concomitant possibility of reward for directors. In other words, not only would risk-taking lead to

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57. *Id.*

58. *Id.* at 875.

liability, the directors have little opportunity to benefit from the risk-taking because they own “a very small proportionate ownership interest in their corporations and little or no incentive compensation.”<sup>59</sup> This reasoning does not apply to inside directors who are also corporate officers. As officers they typically receive considerable compensation that includes a distribution of their company’s stock or options. The disjunction between risk and reward does not exist for managers. Managers are paid higher salaries and receive bonuses based on performance, and they enjoy a good reputation as part of the reward for good outcomes.

Another reason for deferring to boards’ decisions under the business judgment rule is that the board is the final arbiter with respect to the corporation’s affairs. The board exists because of the problems that result from the separation of ownership and control. One of the board’s tasks includes monitoring the conduct of managers<sup>60</sup> who control the corporation on behalf of the residual owners of the company—the shareholders. Managers’ decisions are already subject to review by the board. Officers’ decision-making processes, and the decisions themselves, are supposed to be reviewed by the board, even if not by courts. The board is expected to make final decisions regarding the company; managers are not. The board’s consideration of managerial conduct should include consideration of whether officers, including inside directors, satisfy the duty of care.

The business judgment rule applies to directors’ decision-making because the board is the final arbiter regarding the business and affairs of the corporation. State statutes give boards the power and authority to manage the affairs of the corporation. If the decisions of boards were reviewed by courts as a routine matter, it would be the courts that manage the business of the corporation. That would be inefficient, the argument goes. Every time the decision of one is reviewed by another, the first decision-maker loses the power to make the decision.<sup>61</sup> The same argument cannot be applied to corporate officers; they are not the final decision-makers. Fundamental corporate governance principles subject managerial decision-making to review. If the board decides to pursue a claim against an officer, courts should review the officer’s conduct.

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59. *Gagliardi v. TriFoods Int’l, Inc.*, 683 A.2d 1049, 1052 (Del. Ch. 1996).

60. *See In re Caremark Int’l Inc. Derivative Litig.*, 698 A.2d 959 (Del. Ch. 1996).

61. *See BAINBRIDGE*, *supra* note 7, at 235.

C. *The Relationship Between Insiders and Outsiders in  
Van Gorkom*

How is role differentiation relevant to the facts of *Van Gorkom*? What did Van Gorkom do as a director? What duties did he owe as an officer? As director or officer, Van Gorkom owed duties that were enforceable by shareholders through derivative litigation. Shareholders, however, are not adequately able to hold insiders, such as Van Gorkom, accountable for breaches because of the erosion of the duty of care and the inadequacies of shareholder derivative litigation discussed earlier. Duties owed by inside directors in their roles as corporate officers can best be enforced by independent directors on behalf of shareholders or the corporation as part of the independent directors' duty of care.

Under agency principles, an individual director has no authority to act on the corporation's behalf. The board functions not as the agent of the corporation, but as the corporation itself—the principal. For the board to function as the principal, board action must be collective.<sup>62</sup> The scope of authority of corporate officers includes matters that arise in the ordinary course of business.<sup>63</sup>

The Trans Union directors were not fully informed when they made the initial decision to recommend the Pritzker acquisition to shareholders. The board failed to make the requisite inquiries that would have yielded the information they needed. The board voted to recommend the Pritzker acquisition to Trans Union shareholders even though the directors had not attempted to fully inform themselves about the company's value to the potential acquirer, Pritzker.

In the board meetings that followed, and before the February shareholder vote, the board tried to cure the deficiencies in its decision-making process at the initial meeting. They approved amendments to the agreement that would have enabled the board to satisfy its duty of care. They did so, however, without having read the amendments. It turned out that the content of the amendments was not as described by Van Gorkom. Van Gorkom was not fully informed of the content of the amendments because he had not read them, nor had he sought the advice of counsel with respect to the content of the original or amended agreement.

Van Gorkom acted alone in his initial negotiations with Pritzker. As a director, he had no authority to act for the entire board and, therefore, in exceeding his authority as a director, acted improperly.

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62. *See id.* This requirement of collective action does not preclude judicial review of directors' decision-making processes that distinguish outsiders from insiders. Nor does it preclude outsiders from requiring that insiders satisfy care obligations in their role as officers.

63. *Id.* at 238.

Van Gorkom, as CEO, had no authority to act as agent of the corporation on this extraordinary matter. What was most relevant, however, as far as Van Gorkom's role as CEO was concerned, was that he failed to give complete information to the board about his negotiations with Pritzker.<sup>64</sup> As CEO he should have given complete information about the deal with Pritzker to the board. Providing sufficient information to independent directors was part of the duty of care he owed to the corporation as its CEO. This duty to provide information is a corollary to the independent directors' duty of inquiry. If a duty to inquire is imposed on independent directors, it will be meaningless, or of very little value, without a concomitant duty to come forward with complete and accurate information on the part of insiders.

Similarly, Bruce Chelberg, Trans Union's chief financial officer, and Donald Romans, the company's president and chief operating officer, owed duties not only as directors, but also as officers. The duty of inquiry would have required Chelberg to ask Van Gorkom about the basis for the price at which he agreed to sell the company, instead of acting as Van Gorkom's "yes man." The inside director's duty to inform, as discussed in Part I, would have required that Romans clearly express his initial reservations about the deal to the independent members of the board.

### III. CONCLUSION

Jeffrey Sonnenfeld wrote:

It's time for some fundamentally new thinking about how corporate boards should operate and be evaluated. We need to consider not only how we structure the work of a board but also how we manage the social system a board actually is. We'll be fighting the wrong war if we simply tighten procedural rules for boards and ignore their more pressing need—to be strong, high-functioning work groups whose members trust and challenge one another and engage directly with senior managers on critical issues facing corporations.<sup>65</sup>

This article focuses on the informal relationship between independent and inside board members and the need for independent directors to be clear about what they require from inside directors. More clarity is needed with respect to what officers, particularly insiders, must do to satisfy their duty of care. Inside directors satisfy their duty of care only if they come forward with the complete and accurate information that independent directors need to satisfy the fiduciary duties *they* owe shareholders. This is something that Van Gorkom did not do.

Independent directors should make clear that they expect insiders serving on the board with them to satisfy their duty of care by

64. Van Gorkom may have been plagued by a loyalty issue—his impending retirement.

65. Sonnenfeld, *supra* note 24, at 106.

coming forward with the material information that outsiders need. And, independent directors should monitor inside directors' conduct when they serve the corporation as officers. This requires independent board members to engage in role differentiation by distinguishing the conduct of inside directors as board members from their conduct as corporate officers. For the reasons explained in Part II of this article, this is a difficult but manageable task. Role differentiation is essential in corporate law. When the board reviews the decisions that inside directors make in their role as officers, the board should encourage satisfaction of the articulated and perhaps aspirational duty of care that is described in cases such as *Van Gorkom* and *Caremark*.

Improved communication between inside directors and independent board members may have prevented some of the losses suffered by shareholders and employees of companies such as Enron and WorldCom.<sup>66</sup> Unitary assessment of board conduct precludes the possibility of holding inside directors accountable to the independent directors with whom they serve. Viewing the board collectively destroys individual responsibility. "This certainly appears to have happened at Enron: Practically everyone involved has pointed the finger of blame at others or proclaimed his or her ignorance as a badge of honor."<sup>67</sup>

Even before Enron, the concept of independence on the board was important.<sup>68</sup> "We all owe the shareholder activists, accountants, lawyers, and analysts who study corporate governance a debt: In the 1980s and 1990s, they alerted us to the importance of independent directors . . . ."<sup>69</sup> An increase in the number of independent directors on a board increases the importance of insiders. With more outsiders on the board, with less knowledge of the company, the insider's role amplifies. They have to be diligent, vigilant, and forthcoming with the information independent directors need.

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66. For example, "Enron's chairman and CEO never told the board that whistle-blower Sherron Watkins had raised major questions about financial irregularities." *Id.* at 109.

67. *Id.* at 112-13.

68. PINTO & BRANSON, *supra* note 39, at 118.

69. Sonnenfeld, *supra* note 24, at 113.