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## Judicial Review of Directors' Duty of Care: A Comparison Between U.S. & China

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# JUDICIAL REVIEW OF DIRECTORS' DUTY OF CARE: A COMPARISON BETWEEN U.S. & CHINA

Zhaoyi Li\*

## ABSTRACT

Articles 147 and 148 of the Company Law of the People's Republic of China ("Chinese Company Law") establish that directors owe a duty of care to their companies.<sup>1</sup> However, both of these provisions fail to explain the role of judicial review in enforcing this duty. The duty of care is a well-trodden territory in the United States, where directors' liability is predicated on specific standards. The current American standard, adopted by many states, requires directors to "discharge their duties with the care that a person in a like position would reasonably believe appropriate under similar circumstances."<sup>2</sup> However, both the business judgment rule and Section 102(b)(7) of the Delaware General Corporate Law ("DGCL") shield directors from responsibility for their actions, which may weaken the impact of the duty of care requirement on director behavior.

To better allocate the responsibility for directors' violations of the duty of care and promote the corporations' development, it is essential that Chinese company law establish a unified standard of review governing the duty of care owed by directors

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<sup>1</sup> Zhonghua Renmin Gongheguo Gongsifa (中华人民共和国公司法) [The Company Law of the People's Republic of China] (promulgated by the Standing Comm. Nat'l People's Cong., effective Oct. 26, 2018) art. 147, 148.

<sup>2</sup> MODEL BUS. CORP. ACT ANN. § 8.30(B) (AM. BAR ASS'N 2016).

to companies. The majority of Chinese legal scholars agreed that a combination of subjective and objective standards would function best.<sup>3</sup> Questions remain regarding how to combine such standards and implement them. In order to promote the development of China's duty of care, these controversial issues need to be solved. This Article argues that China's Company Law should hold a first-time violator of the duty of care liable only in cases of gross negligence but hold directors liable in the cases of ordinary negligence if they have violated the duty of care in the past.

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<sup>3</sup> See, e.g., Xinyuan Shi (史欣媛), Mubiaogongsi Dongshixinyiyiwu Pandingbiaozhun De Lujingjiangou—Yi Meiguo he Yingguo Shijian Wei Shijiao (目标公司董事信义义务判定标准的路径建构——以美国和英国实践为视角) [Establishment of Standards for Determining Fiduciary Duty of Target Company Directors—From the Perspective of American and British Practice], GANSUZHENGFA DAXUE XUEBAO (甘肃政法大学学报) [JOURNAL OF GANSU UNIVERSITY OF POLITICAL SCIENCE AND LAW], 77, 88 (2021).

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## INTRODUCTION

When parties entrust their property to a third-party, such as a director, directors must use their professional knowledge to make decisions and supervise the operation of corporations.<sup>4</sup> With the parties vulnerable to the influence of the invited person's behavior, the invited person owes a duty of care to the entrustor.<sup>5</sup> The purpose of establishing fiduciary duties is to eliminate the desire to sacrifice the beneficiary's interests,<sup>6</sup> and ensure that trustees do not exploit and manipulate the vulnerability of the trusting parties. The standard for determining whether directors have breached their duty of care is crucial to courts. Directors' duty of care in corporate law evolved from negligence in tort law.<sup>7</sup> The rationale underlying negligence theories is that people need to be cautious if their work may cause harm to others.<sup>8</sup> Otherwise, they should be held responsible for the harm they cause.

According to the Delaware Supreme Court, directors must "consider all material information reasonably available" when making business decisions,<sup>9</sup> and can be sued for their actions when their conduct is grossly negligent.<sup>10</sup> As two commentators stated, "the genius of Delaware lawmakers lies in their ability to

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<sup>4</sup> Daniel B. Kelly, *Fiduciary Principles in Fact-Based Fiduciary Relationships*, in THE OXFORD HANDBOOK OF FIDUCIARY LAW 3, 7 (Evan J. Criddle, Paul B. Miller & Robert H. Sitkoff eds., 2019); Paul B. Miller, *A Theory of Fiduciary Liability*, 56 MCGILL L.J. 235, 261–62 (2010).

<sup>5</sup> *Id.*

<sup>6</sup> Joshua Getzler, *Ascribing and Limiting Fiduciary Obligations: Understanding the Operation of Consent*, in PHILOSOPHICAL FOUNDATIONS OF FIDUCIARY LAW 39, 41 (Andrew S. Gold & Paul B. Miller eds., 2014).

<sup>7</sup> See Melvin A. Eisenberg, *The Duty of Care of Corporate Directors and Officers*, 51 U. PITT. L. REV. 945, 945 (1990).

<sup>8</sup> *Id.*

<sup>9</sup> *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984). This Article mainly discusses Delaware corporate law because many companies are incorporated in Delaware and other states and countries often refer to Delaware corporate law to formulate their own statutory and common law. According to the State of Delaware website, Delaware is "a leading domicile for U.S. and international corporations. More than 1,000,000 business entities have made Delaware their legal home. More than 66% of the Fortune 500 have chosen Delaware as their legal home." See *About the Division of Corporations*, DELAWARE.GOV: DEL. DIV. CORPS., <https://corp.delaware.gov/aboutagency/> [<https://perma.cc/QZA7-WVZ8>]; see also Nadelle Grossman, *Director Compliance with Elusive Fiduciary Duties in a Climate of Corporate Governance Reform*, 12 FORDHAM J. CORP. & FIN. L. 393, 397 (2007); *How Delaware Became No. 1*, N.Y. TIMES (May 9, 1976), <https://www.nytimes.com/1976/05/09/archives/how-delaware-became-no-1.html> [<https://perma.cc/Q2XT-HUVV>].

<sup>10</sup> *Brehm v. Eisner*, 746 A.2d 244, 259 (Del. 2000).

generate a thick fiduciary law without at the same time imposing a significant compliance burden.”<sup>11</sup> Delaware’s corporate law separates directors’ duty of care standard of conduct and the standard of review.<sup>12</sup> Combined with gross negligence, this distinction results in a less stringent duty of care.

China increased the duty of care expected of directors in 2005,<sup>13</sup> but the Company Law does not provide a specific duty of care standard.<sup>14</sup> As a result, Chinese courts have applied different standards of review to similar cases, leading to inconsistent outcomes.<sup>15</sup> Some courts have not even discussed the standard of review.<sup>16</sup> This Article suggests that the lack of a duty of care standard for directors in Chinese law be rectified by using whether the director has violated the duty of

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<sup>11</sup> See William W. Bratton & Joseph A. McCahery, *The Equilibrium Content of Corporate Federalism*, 41 WAKE FOREST L. REV. 619, 691 (2006).

<sup>12</sup> See BRIAN JM QUINN, *Standards of Conduct and Standards of Review*, in AN INTRODUCTION TO THE LAW OF CORPORATIONS: CASES AND MATERIALS loc. 4.1 (2020) (ebook), <https://opencasebook.org/casebooks/553-an-introduction-to-the-law-of-corporations-cases-and-materials/resources/4.1-standards-of-conduct-and-standards-of-review/> [<https://perma.cc/4JCR-JPF6>]. The standard of conduct refers to the criteria that directors should comply with when they fulfill their fiduciary duties while the standard of review is adopted by courts to assess whether the directors’ behavior is qualified. For a fuller explanation, see *infra* Part II.

<sup>13</sup> Shaowei Lin & Lin, *Directors’ Duty of Care in China: Empirical and Comparative Perspective*, 13 TSINGHUA CHINA L. REV. 295, 300 (2021). “Directors, supervisors and senior officers shall abide by laws, administrative regulations and the articles of association of the company, and have a fiduciary obligation and obligation of diligence to the company.” *Zhonghua Renmin Gongheguo Gongsifa* (中华人民共和国公司法) [The Company Law of the People’s Republic of China] (promulgated by the Standing Comm. Nat’l People’s Cong., effective Oct. 26, 2018) art. 147.

<sup>14</sup> The Shenzhen Intermediate People’s Court stated that the Company Law does not clearly stipulate the judicial review standards of directors’ duty of care. This means that the lack of specific standards brings difficulties to the judicial practice of the court. *Zhongguo Huarongzichanguanligufenyouxiangongsi Shenzhenshifengongsi, Shenzhenshi Guofenglvveyuleyouxiangongsi Deng Gudongchuzijiufer Ershenpanjueshu* (中国华融资产管理股份有限公司深圳市分公司、深圳市国丰旅业娱乐有限公司等股东出资纠纷二审判决书) [Huarong Asset Mgmt. Co., Shenzhen Branch, Shenzhen Guofeng Tourism Ent. Co., and other shareholders’ investment dispute civil judgment], Shenzhen Interm. People’s Ct. No. 14642 (Mar. 21, 2019).

<sup>15</sup> Jun Wang (王军), *Gongsijingyingzhe Zhongshiheqinmianyiwususong Yanjiu* (公司经营者忠实和勤勉义务诉讼研究——以 14 省、直辖市的 137 件判决书为样本) [On Actions against Directors or Officers for Breaching the Duty of Loyalty or the Duty of Care: An Empirical Study Based on 137 Cases from 14 Provinces in China], BEIFANG FAXUE (北方法学) 4 NORTHERN LEGAL SCIENCE [N. LEGAL SCI.] 24, 31, 39 (2011).

<sup>16</sup> Liu Huayu Yu Chongqing Ruiennongyeyouxiangongsi Sunhaigongsiliyizerenjiufen Shangsu An (刘化雨与重庆瑞恩农业有限公司损害公司利益责任纠纷上诉案) [Liu Huayu v. Chongqing Ruien Agric. Co.], Chongqing Fifth Interm. People’s Ct. No. 02635 (July 24, 2014).

care in the past as the criterion to judge whether ordinary negligence or gross negligence standard is imposed on the violating directors.

This Article proceeds in four parts. Part I briefly surveys the application of the duty of care in Chinese courts and demonstrates the shortcomings of the vague duty of care standards in the Chinese Company Law, emphasizing the need for change. Part II examines and analyzes Delaware corporate law's dichotomy between the standard of conduct and the standard of review for gross negligence. It contends that Delaware's duty of care has gradually lost its practical significance. This Article offers suggestions so that the duty of care can once again play its practical role in supervising directors' behavior based on opinion-crafting. Part III argues that Chinese Company Law should choose whether or not a strict standard applies based on the director's past violations. Part IV offers concluding remarks.

## I. DUTY OF CARE'S ENFORCEMENT IN CHINA

With the further expansion of globalization, people all over the world began to make efforts to understand the specific requirements of Chinese Company Law. The rapidly developing Chinese market has attracted many countries on an international level, leading to a multitude of foreign companies investing or setting up branches in China. Understanding Chinese Company Law will help the corporate governance of foreign companies and multinational corporations. This section selects representative cases to analyze the current nature of directors' duty of care in China's judicial decisions.

### A. *How do Chinese Judges Rule in Duty of Care Cases?*

Due to the lack of uniform provisions regarding the duty of care standards, various Chinese courts have applied disparate standards.<sup>17</sup> In most cases, instead of making a specific analysis of the standard of duty of care, judges broadly cite Article 147 or 148 of the Chinese Company Law in their judgments.<sup>18</sup> The burden of proof is heavy. The parties who cannot provide evidence proving their innocence face adverse consequences under such a heavy burden.<sup>19</sup> Even in cases that reference the

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<sup>17</sup> Wang, *supra* note 15.

<sup>18</sup> All cases are listed on PKULAW.COM (北大法宝). See, e.g., Liu Huayu Yu Chongqing Ruiennongyeyouxiangongsi Sunhaigongsiliyizerenjiufen Shangsuo An (刘化雨与重庆瑞恩农业有限公司损害公司利益责任纠纷上诉案) [Liu Huayu v. Chongqing Ruien Agric. Co.], Chongqing Fifth Interm. People's Ct. No. 02635 (July 24, 2014).

<sup>19</sup> See, e.g., Sichuan Huineng YouseJinshu Gufenyouxiangongsi Yu Lishiquan deng Sunhai Gongsiliyizeren Jiufen An (四川慧能有色金属股份有限公司与李世全等损害公司利益责任纠纷案)

standard of duty of care, the rules are not uniform or consistent because different courts apply different interpretations of Articles 147 and 148.<sup>20</sup>

Some courts have noted that directors should exercise the duty of care of an ordinarily prudent person.<sup>21</sup> In *Yongfa Co. v. Tang*,<sup>22</sup> the court explicitly held that directors should act with the care that an ordinary person would reasonably be expected to exercise in a like position and under similar circumstances.<sup>23</sup> Due to the defendants' negligence, the defendants were ordered to compensate the plaintiffs for the economic loss of 3.4227 million yuan, plus interest.<sup>24</sup> Under the standard applied in this case, as long as directors argue that they are not experts in court, they can escape legal sanction. Another loophole within this standard is that corporations may choose to hire replaceable directors, while highly capable directors may not be hired.

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[Sichuan Huineng Nonferrous Metals Co. v. Li], Sichuan High People's Ct. No. 667 (Dec. 8, 2014); *see also* Qinghaijinsanjiao Mianfenyouxiangongsi Yu Majingsheng and Baimingjie Deng Sunhaigongsiliyizerenjiufen (青海金三角面粉有限公司与马旌升、白明杰等损害公司利益责任纠纷) [Qinghai Golden Triangle Flour Co. v. Ma Jingsheng and Bai Mingjie], Qinghai High People's Court No. 92 (July 19, 2019).

<sup>20</sup> Wang, *supra* note 15, at 39.

<sup>21</sup> *See, e.g.*, Neimenggu Zhongrongrongye Youxian Gongsi Yu Zhangxilun Sunhai Gongsiliyizeren Jiufenshangsu An (内蒙古中绒绒业有限公司与张希伦损害公司利益责任纠纷上诉案) [Inner Mongolia Zhongrong Cashmere Co. v. Zhang], Inner Mongolia Xingan League Interim. People's Ct. No. 237 (June 5, 2017) (stating that the director's duty of care requires that the director perform his duty in the best interests of the company, with the care of a good custodian and the reasonable care of an ordinarily prudent person); Yangbaojianag Yu Nanning Zhongye Kuangyuan Gongsi Sunhaigongsiliyizeren Jiufenshangsu An (杨保疆与南宁中冶矿源公司损害公司利益责任纠纷上诉案) [Yang Baojiang v. Nanning Zhongye Mining Res. Co.], Nanning Interim. People's Ct. No. 467 (Mar. 24, 2014) (expressing the opinion that directors should exercise the same due care as an ordinarily prudent person would in a similar position and circumstances); *see also* Hubeienshi Tielianwuzimaoyiyouxiangongsi Su Zhangjie Deng Sunhaigongsiliyizerenjiufen An (湖北恩施铁连物资贸易有限公司诉张杰等损害公司利益责任纠纷案) [Hubei Enshi Tielian material Trade Co. v. Zhang], Enshi Interim. People's Ct. No. 00457 (Sept. 19, 2015); Chen Chunhua and Wu Xiaohu's appeal on the dispute of compensation for the damage to the company's interests (陈春华等与吴小虎公司董事损害公司利益赔偿纠纷案) [Chen v. Wu], Zhejiang High People's Ct. No. 37 (July 19, 2010) (stating that the duty of care requires directors to perform their duties to the company in good faith, be diligent and prudent in managing the company, and fulfilling their duties with the care of a reasonable and prudent person in similar situations.).

<sup>22</sup> Rongchangxianyongfashichangguanli Youxiangongsi Yu Tangxiangsheng、Yangdaping deng Sunhaigongsiliyizeren Jiufen An (荣昌县永发市场管理有限公司与汤祥生、杨大平等损害公司利益责任纠纷案) [Rongchang Yongfa Market Mgmt. Co. v. Tang], Chongqing Fifth Interim. People's Ct. No. 02809 (Dec. 30, 2015).

<sup>23</sup> *Id.*

<sup>24</sup> *Id.*



High-ability directors are likely to lower their workload and avoid risky proposals even though they may bring huge benefits to the company as a result.<sup>25</sup>

Other Chinese courts have held that there is a duty for directors to have the ability and prudence needed for their positions.<sup>26</sup> In *Zhao v. Jiangsu Sunan Tezhong Co.*,<sup>27</sup> the court held the defendant director negligent for his failure to complete a project audit within seventy days as required by the contract.<sup>28</sup> The court required the defendant to compensate the plaintiff company for 60% of its loss.<sup>29</sup>

The Standing Committee of the 13th National People's Congress reviewed the draft revision of the Chinese Company Law in December 2021.<sup>30</sup> Similarly, the draft stipulates that directors should exercise the reasonable care that directors usually take to promote their company's best interests.<sup>31</sup> The revised draft is now in the stage of soliciting opinions from the public. This Article argues that it is not advisable to apply an ordinary negligence standard uniformly. Certain directors can and have become directors through nepotism by controlling shareholders while lacking the professional talent and skillset to become directors. Therefore, treating every director as an expert may make a large number of directors bear an unfair responsibility. For example, after *Van Gorkom* was decided, a group of independent directors of Chinese listed companies resigned within two weeks of the judgment. They feared

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<sup>25</sup> Jianwen Wang & Feijian Xu (王建文 & 许飞剑), *Gongsigaoguan Qinmianyiwupanduanbiaozhun De Gouzhao: Waiguojingyan Yu Zhongguo Fangan* (公司高管勤勉义务判断标准的构造: 外国经验与中国方案) [The Constitution of Judgement Standard of Corporate Top Manager's Diligence Duty: Foreign Experience and Chinese Project], *NANJING SHEHUIKEXUE* (南京社会科学) [NANJING JOURNAL OF SOCIAL SCIENCES] 110, 112 (2012).

<sup>26</sup> *See, e.g.*, Chenmou, Yumou Deng Yu Dengmou Deng Sunhai Gongsiliyizeren Jiufen Yishenminshipanjueshu (陈某、余某等与邓某等损害公司利益责任纠纷一案一审民事判决书) [Deng and Liu v. Chen and Yu], Huangshigang Primary People's Ct., Huangshi, Hubei, No. 407 (Nov. 26, 2020) (stating that the duty of care requires the directors to perform the same level of management that their counterparts in similar companies in similar positions would have in similar situations.).

<sup>27</sup> Zhaohaihua Deng Su Jiangsusunantezhongzhuangbeijituanyouxianzerengongsi Sunhaigongsiliyizeren Jiufen An (赵海花等诉江苏苏南特种装备集团有限责任公司损害公司利益责任纠纷案) [Zhao et al. v. Jiangsu Sunan Tezhong Co., Ltd.], Suzhou Interm. People's Ct. No. 0164 (2014).

<sup>28</sup> *Id.*

<sup>29</sup> *Id.*

<sup>30</sup> Huaxia, *Chinese Lawmakers Review Legal Amendments to Improve Corporate Governance*, XINHUANET (Dec. 12, 2021), [http://www.news.cn/english/2021-12/20/c\\_1310384482.htm](http://www.news.cn/english/2021-12/20/c_1310384482.htm) [https://perma.cc/7NJ7-2684].

<sup>31</sup> Draft Amendment to the Company Law, Article 180 (2021).

they would have to sustain similar responsibilities to the five directors of Kangmei Pharmaceutical who violated their duty of care and were sentenced to compensate for 10% of the total loss, that is, a fine of 240 million yuan.<sup>32</sup> Thus, such strict standards and liability may affect the development of both corporations and corporate governance.

Instead of using the gross negligence standard,<sup>33</sup> some courts have ruled differently and have directly exempted directors according to the business judgment rule. In *Gong v. Sun Chao*,<sup>34</sup> the shareholders believed that Gong and other directors violated their duty of care based on the fact that Gong published the company's certificate revocation statement without authorization.<sup>35</sup> The court here held that the business judgment rule should be considered when determining directors' liability.<sup>36</sup>

Some courts have even equated company compliance with the duty of care.<sup>37</sup> In *Guangdong Pinhong Decoration Engineering Co. v. Zhou*,<sup>38</sup> the court stated that executive director Zhou did not perform his duty of care because he left the company without going through the handover procedures, thereby impacting the operation of the company.<sup>39</sup> Despite the court's ruling that the duty of care had been violated, leaving the company is violative of neither the laws nor the bylaws and does not

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<sup>32</sup> Guangzhou Interim. People's Ct. No. 2171 (Nov. 12, 2021).

<sup>33</sup> China has not introduced the business judgment rule officially. See, e.g., *Jiangyanbingguanyouxiangongsi Yu Yinwen Sunhaigongsiliyizeren Jiufen* (姜堰宾馆有限公司与殷文损害公司利益责任纠纷) [*Jiangyan Hotel Co. v. Yin*], Taizhou Interim. People's Ct. No. 1011 (June 4, 2019) (stating that the director would violate the duty of care if the director showed gross negligence and a causal relationship between gross negligence and the company's losses exists).

<sup>34</sup> *Gongbo Deng Yu Sunchao Deng Gongsiliyizerenjiufenshangsu An* (宫波等与孙超等公司利益责任纠纷上诉案) [*Gong et.al v. Sun et.al*], Hefei Interim. People's Ct. No. 7360 (Feb. 6, 2017).

<sup>35</sup> *Id.*

<sup>36</sup> *Id.*

<sup>37</sup> See, e.g., *Ningbo Jinhecityyouxiangongsi Su Zhangweize Gongsiliyizerenjiufen An* (宁波金合磁铁有限公司诉章卫泽公司利益责任纠纷案) [*Ningbo Jinhe Magnet Co. v. Zhang*], Yinzhou Primary People's Ct., Ningbo, Zhejiang, No. 68 (July 18, 2013) (stating that the requirements of the duty of care include: (1) the liability of directors is based on the directors' violation of laws, administrative regulations, or the charter; (2) the directors must have subjective intention or negligence; (3) the company suffers losses; (4) there is a causal relationship between the breach of duty of care and the company's losses).

<sup>38</sup> *Guangdong Pinhongzhuangshigongcheng Youxian Gongsi, Zhoujiangen Sunhai Gongsi Liyizeren Jiufen Ershen Minshipanjueshu* (广东品鸿装饰工程有限公司、周建良损害公司利益责任纠纷二审民事判决书) [*Guangdong Pinhong Decoration Engineering Co. v. Zhou*], Guangzhou Interim. People's Ct. No. 19538 (Dec. 8, 2020).

<sup>39</sup> *Id.*

directly cause losses for the company.<sup>40</sup> The existing evidence did not prove that there was a direct causal relationship between Zhou's departure and the company's profit decline.<sup>41</sup>

*B. Why do Standards Need to be Stipulated?*

Without a unified standard of care, directors may attempt to conform their behaviors according to their one-sided understanding of the duty of care, which is defined from the perspective of what is most beneficial to them.<sup>42</sup> Meanwhile, the losing parties are incentivized to appeal or seek a new trial in hopes that the second court will adopt a standard of care more favorable for their goals. In addition, due to the lack of a clear duty of care standard, the judgments state that the director violates both the duties of loyalty and care, no matter which specific duty the director actually breaches.<sup>43</sup> Therefore, in future revisions of the Company Law, formulating the duty of care standards would enable it to have a more concrete and substantive meaning.

China did not introduce clear standards of directors' duty of care in 2005,<sup>44</sup> and this might have been due to the lack of duty of care cases in judicial practice, which led to a lack of an empirical basis from which to formulate standards. Seventeen years have passed, and now there is enough meaningful enforcement within the duty of care cases for reference. Another reason a clear standard of directors' duty of care was not introduced might be that legislators wanted to give judges discretion to meet the different needs of each case. For example, in order to provide law enforcement agencies with discretion and enable them to adjust the supervision scope according to the development of the times, the U.S. Federal Trade Commission ("FTC") did not specify the specific connotation of "unfair" and "deceptive" practices prohibited by it.<sup>45</sup> Judges can have a certain degree of discretion, but the different judgments in

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<sup>40</sup> *Id.*

<sup>41</sup> *Id.*

<sup>42</sup> See, e.g., Ari Ezra Waldman, *Privacy Law's False Promise*, 97 WASH. U. L. REV. 773, 776 (2020); see also Danielle D'Onfro, *Companies as Commodities*, 48 FLA. ST. U. L. REV. 1, 57 (2020) (exemplifying the disadvantage of providing too much discretion to legally bound parties such as companies).

<sup>43</sup> See, e.g., Chen Shaofeng Deng Su Zheng Min Gongsiliyizerenjiufen An (陈少峰等诉郑敏公司利益责任纠纷案) [Chen Shaofeng v. Zheng Min], Guangzhou Interm. People's Ct. No. 430 (Nov. 14, 2014).

<sup>44</sup> For a full explanation, see Ciyun Zhu (朱慈蕴), *Lun Zhongguo Gongsifa Bentuhua Yu Guojihua de Ronghe* (论中国公司法本土化与国际化的融合) [The Chinese Corporate Law in Domestic and International Fusion], DONGFANG FAXUE (东方法学) [ORIENTAL LAW], 91, 95 (2020).

<sup>45</sup> Evan J. Criddle, *Fiduciary Foundations of Administrative Law*, 54 UCLA L. REV. 117, 137 (2006).

similar cases caused by excessive discretion may lead to a high appeal rate and a waste of judicial resources. Such a result brought by excessive discretion will lead to trial outcomes deviating from the original intention of legislators.

Therefore, a clarification of the standard of the duty of care should encourage directors to evaluate their current decision-making results before making decisions and encourage directors to take more care in their decision-making process.<sup>46</sup> Clarification will also guide judges on how to determine what kind of behavior violates the duty of care. The following sections will conduct a comparative study to analyze both Delaware's and China's duty of care and propose a standard that is better suited to China's conditions.

## II. AN OVERVIEW AND RECONSIDERATION OF THE STANDARDS OF DUTY OF CARE IN THE U.S.

Delaware became a leading model of corporate law in the U.S. in the twentieth century<sup>47</sup> when Delaware courts began to examine the standard of review of directors' business decisions.<sup>48</sup> The duty of care established by Delaware courts provides a useful comparison for establishing a better Chinese standard for the duty of care.

### A. *Standard of Conduct and Standard of Review*

In Delaware corporate law, the standards of conduct and standards of review are distinct.<sup>49</sup> Instead of directly considering whether a duty exists and was violated, the Delaware court's judgment on any breach of the duty of care is grounded in the standard of review. Standards of review refer to the examination standard applied by the court when analyzing directors' behavior in the case.<sup>50</sup> Standards of conduct refer

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<sup>46</sup> Stephen J. Lubben & Alana J. Darnell, *Delaware's Duty of Care*, 31 DEL. J. CORP. L. 589, 592 (2006) (believing that the hindsight review will reduce judicial transparency and result in additional costs and mistakes due to the lack of standards *ex ante*).

<sup>47</sup> See Sarath Sanga, *The Origins of the Market for Corporate Law* (Mar. 3, 2020), <https://ssrn.com/abstract=3503628> [<https://perma.cc/WG8V-EA6F>].

<sup>48</sup> *Bryan v. Aikin*, 82 A. 817, 820 (Del. Ch. 1912) is the first case related to this issue ruled by the Delaware court. For a fuller explanation, see DAVID KERSHAW, *THE FOUNDATIONS OF ANGLO-AMERICAN CORPORATE FIDUCIARY LAW* 77, 89 (2018).

<sup>49</sup> See Melvin A. Eisenberg, *The Divergence of Standards of Conduct and Standards of Review in Corporate Law*, 62 FORDHAM L. REV. 437, 437 (1993) (putting forward the divergence in the first place); J. Travis Laster, *Revlon Is a Standard of Review: Why It's True and What It Means*, 19 FORDHAM J. CORP. & FIN. L. 5, 26 (2013).

<sup>50</sup> See Eisenberg, *supra* note 49, at 437.

to the standards to be followed by directors when they perform their jobs.<sup>51</sup> These two standards are similar in tort law.<sup>52</sup> The justification for this difference lies in reducing directors' risk and encouraging them to make decisions in pursuit of shareholders' interests without worrying about personal liability.<sup>53</sup> In general, directors are paid modestly in light of their scope of liability.<sup>54</sup> If a director has to bear serious monetary fines due to making wrong business decisions, then this director and other directors will excessively avoid risks in the future, which may result in losses of profit opportunities, which is not in the interests of shareholders.<sup>55</sup> At the same time, courts lack the expertise to assess directors' actions, especially in hindsight,<sup>56</sup> which renders it difficult to reconstruct the decision-making context.<sup>57</sup>

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<sup>51</sup> *Id.*

<sup>52</sup> The standard of conduct and review of tort law are ordinary care and negligence respectively. There is typically no significant difference between the standard of conduct and the standard of review in tort law because bad results usually come from bad decisions. See William T. Allen, Jack B. Jacobs & Leo E. Strine, Jr., *Realigning the Standard of Review of Director Due Care with Delaware Public Policy: A Critique of Van Gorkom and Its Progeny as a Standard of Review Problem*, 96 NW. U. L. REV. 449, 454 (2002) [hereinafter *A Critique of Van Gorkom*].

<sup>53</sup> William T. Allen, Jack B. Jacobs & Leo E. Strine, Jr., *Function Over Form: A Reassessment of Standards of Review in Delaware Corporation Law*, 26 DEL. J. CORP. L. 859, 868 (2002) [hereinafter *Function Over Form*].

<sup>54</sup> Lyman P.Q. Johnson, *Rethinking Judicial Review of Director Care*, 24 DEL. J. CORP. L. 787, 819 (1999) (articulating why judicial deference is implemented).

<sup>55</sup> *Id.*

<sup>56</sup> See, e.g., Hal R. Arkes & Cindy A. Schipani, *Medical Malpractice v. The Business Judgment Rule: Differences in Hindsight Bias*, 73 OR. L. REV. 587, 587 (1994) ("Hindsight bias is the tendency for people with knowledge of an outcome to exaggerate the extent to which they believe that outcome could have been predicted."); see also Johnson, *supra* note 54, at 822 ("[I]nstitutional incompetence of public officials to evaluate the substantive quality of private sector business decisions.").

<sup>57</sup> Many articles illustrated the policy reasons why Delaware courts choose to not conflate the standards of conduct and of review. See, e.g., *A Critique of Van Gorkom*, *supra* note 52, at 454–56 (explaining that the first reason is to ensure that directors do not take unfair liability. Business decisions are generally formulated in a limited time and under the background of incomplete information, which makes business behavior itself accompanied by high risk. If the standards of review are the same as the standards of conduct, the judge may regard directors' rational decisions which happened to have bad outcomes as wrong decisions afterward. The second reason is that choosing a high-risk business plan is conducive to maximizing shareholders' income, because high-risk business decisions may bring much higher benefits than low-risk decisions. The third reason is that other strategies such as the removal of unqualified directors, maybe more helpful to market development.); see also *Function Over Form*, *supra* note 53, at 868 ("[C]ourts are ill-equipped to determine after-the-fact whether a particular business decision was reasonable in the circumstances confronting the corporation.").

The standard of conduct for directors' duty of care, which defines how corporate decisions makers should behave, is ordinary care.<sup>58</sup> The standard of conduct requires directors to "inform themselves, prior to making a business decision, of all material information reasonably available to them."<sup>59</sup> If directors are judged according to the standards they should abide by, then the standard of review should be ordinary negligence. However, standards of conduct are considered unenforceable in legal practice and this notion is supported by academia.<sup>60</sup> The standard of review on the duty of care is "whether the complaint has alleged facts supporting a reasonably conceivable inference that the directors were grossly negligent."<sup>61</sup>

Professor Melvin Eisenberg states that standards of conduct have value and that "they are legal rules intended to control behavior."<sup>62</sup> Several scholars proposed the concept of "nonlegally enforceable rules and standards,"<sup>63</sup> which may be suitable for describing standards of conduct. It should be noted that it is not easy for Delaware courts to balance the duty of care's standards of conduct and review. Setting harsh standards will subject Delaware courts to the state legislature's interference, while

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<sup>58</sup> See MODEL BUS. CORP. ACT ANN. § 8.30 (2020). The American Bar Association formulated the Model Business Corporation Act, which has influenced the formulation of many states' corporate laws. MODEL BUS. CORP. ACT ANN. § 8.30 (b) (2020) stipulates the standards of conduct for directors and forms the baseline by which directors' actions will be judged: "The members of the board of directors or a board committee, when becoming informed in connection with their decision-making function or devoting attention to their oversight function, shall discharge their duties with the care that a person in a like position would reasonably believe appropriate under similar circumstances."

<sup>59</sup> *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984).

<sup>60</sup> See Julian Velasco, *The Role of Aspiration in Corporate Fiduciary Duties*, 54 WM. & MARY L. REV. 519, 522 (2012) (articulating the rationale behind the exhortation and nonlegal enforcement of the duty of care); see also *Function Over Form*, *supra* note 53, at 866 (believing that the reason why courts rely on the review standard is that the information by which directors make decisions may change from time to time, and different directors may take various actions in different periods, which makes the idea of the court formulating standards in advance inconsistent with reality).

<sup>61</sup> *In re Books-A-Million, Inc. Stockholders Litigation*, C.A. No. 11343-VCL, 2016 WL 5874974, at \*1, 17 (Del. Ch. Oct. 10, 2016).

<sup>62</sup> See Eisenberg, *supra* note 49, at 464 (1993); Velasco, *supra* note 60, at 525 (supporting Eisenberg's opinion on this issue).

<sup>63</sup> See Edward B. Rock & Michael L. Wachter, *Islands of Conscious Power: Law, Norms, and the Self-Governing Corporation*, 149 U. PA. L. REV. 1619, 1643 (2001) (theorizing how corporate law promotes autonomy through inapplicable standards and allows the parties in corporate governance to decide the degree of court intervention).

loose standards might lead to dissatisfaction in Congress or cause a negative impact on the reputation of Delaware judges in corporate governance.<sup>64</sup>

The inconsistency between the standard of conduct and the standard of review enables courts to set certain requirements for directors' conduct and set a less demanding and more forgiving standard to decide whether directors should take responsibility. This way, courts are able to keep the basic theory of corporate law and optimize the review standard according to new developments in corporate governance.<sup>65</sup> The ideal situation is that a higher standard of conduct encourages directors to fulfill their duties conscientiously and a lower standard of review encourages directors to make bold decisions. However, as one of the Delaware courts' Vice-Chancellors argues, "standard of conduct is dominated by deferential standard of review," and together with the ineffective execution mechanism, these measures have downplayed the role of standard of conduct.<sup>66</sup> The divergence between the standard of conduct and the standard of review is worth discussing. It is inevitable that some directors conduct themselves according to the standard of review and reduce the degree of requirements of their job, which may make the dichotomy unable to achieve the expected effect. The standard of review is lower than the standard of care; directors are not held responsible for conduct that breaches the duty of care but is not egregious enough to be scrutinized by the courts. This divergence undermines the duty of care. As a result, the directors may not actively perform according to their duty of care.

### B. Gross Negligence Standard

The basis of directors' duty of care lies in tort law that states that "each person owes a duty to those who may foreseeably be harmed by her action to take such steps

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<sup>64</sup> See William W. Bratton, *Lyondell: A Note of Approbation*, 55 N.Y. L. SCH. L. REV. 561, 565 (2010). For example, *Smith v. Van Gorkom* applied a strict duty of care standard of review, which damaged the reputation of the Delaware court. After listening to the presentation of Van Gorkom (CEO) at the two-hour board meeting, the board approved a merger at a price exceeding the market price. The plaintiffs sued on the ground that the directors were not informed. The Delaware Supreme Court held that the business judgment rule is not able to protect directors because the board did not fully investigate how \$55 per share was obtained. *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985). The court's decision resulted in limited coverage and increased premiums in the directors' liability insurance market. *Id.*

<sup>65</sup> See Katie Clemmons, *Dissecting Revlon: Severing the Standard of Conduct from the Standard of Review in Post-Closing Litigation*, 73 VAND. L. REV. 267, 308 (2020) (explaining that the purpose of distinguishing standards of conduct from standards of review is to avoid frequent revision of standards that do not meet corporations' new characteristics).

<sup>66</sup> See J. Travis Laster, *Fiduciary Duties in Activist Situations*, 13 VA. L. & BUS. REV. 75, 99 (2019).

as a reasonably prudent person would take in similar circumstances to avoid such harm to others.”<sup>67</sup> American courts experienced a series of evolutions regarding the duty of care standards. There are many different versions of the standard of duty of care. One version is the ordinary care standard. The ordinary care standard requires that directors “exercise ordinary care and prudence in the administration of the affairs of a bank,”<sup>68</sup> to “the same degree of care and prudence that men prompted by self-interest generally exercise in their own affairs,”<sup>69</sup> as well as what a “prudent” person would have used in a like situation.<sup>70</sup> Because most people are generally more concerned about their own affairs than the affairs of others, the third standard of “prudent” person is less demanding than the second standard.

In tension with these duties of care is the business judgment rule.<sup>71</sup> The business judgment rule transforms the duty of care’s standard of review from the negligence standard to the gross negligence standard under *Aronson*.<sup>72</sup> Situations where the business judgment rule can be overturned include “conflicts of interest, corporate waste, or egregious procedural impropriety.”<sup>73</sup> Gross negligence is now the standard to judge whether directors are liable for breaching the duty of care in Delaware

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<sup>67</sup> Harris v. Carter, 582 A.2d 222, 234–35 (Del. Ch. 1990); but see Julian Velasco, *A Defense of the Corporate Law Duty of Care*, 40 J. CORP. L. 647, 675–76 (2015) (listing justifications that corporate duty of care cannot be considered as a tort duty. First, the standard of conduct of duty of care in tort law is the same as that of review, but these two standards are different in corporate law. Second, corporate law does not examine the content of a board’s choice, but tort law does analyze the subject matter. Third, the main purpose of the duty of care in tort law is to indemnify the victims, while the corporate duty of care seldom does the same thing, and its purpose is to safeguard shareholders’ interests from damage by using legal deterrence to regulate directors’ behavior.).

<sup>68</sup> See, e.g., Briggs v. Spaulding, 141 U.S. 132, 165–66 (1891).

<sup>69</sup> Hun v. Cary, 82 N.Y. 65, 71 (1880); for a fuller explanation of duty of care’s history, see DAVID KERSHAW, *THE FOUNDATIONS OF ANGLO-AMERICAN CORPORATE FIDUCIARY LAW* 174 (2018).

<sup>70</sup> Graham v. Allis-Chalmers Mfg. Co., 188 A.2d 125, 130 (Del. 1963).

<sup>71</sup> Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) (“[A] presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.”).

<sup>72</sup> See Reza Dibadj, *Disclosure as Delaware’s New Frontier*, 70 HASTINGS L.J. 689, 694 (2019).

<sup>73</sup> Paul B. Miller & Andrew S. Gold, *Fiduciary Governance*, 57 WM. & MARY L. REV. 513, 581–82 (2015).



courts.<sup>74</sup> The adoption of gross negligence is closely related to three cases: *Aronson v. Lewis*,<sup>75</sup> *Smith v. Van Gorkom*,<sup>76</sup> and *Walt Disney*.<sup>77</sup>

Gross negligence refers to conduct that is worse than ordinary negligence, reflected in a “devil-may-care attitude or indifference to duty amounting to recklessness;”<sup>78</sup> and it is “a higher level of negligence representing ‘an extreme

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<sup>74</sup> *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984) (“While the Delaware cases use a variety of terms to describe the applicable standard of care, our analysis satisfies us that under the business judgment rule director liability is predicated upon concepts of gross negligence.”); *Penn Mart Realty Co. v. Becker*, 298 A.2d 349, 351 (Del. Ch. 1972) (“Fraud and self-dealing are not the only ways in which corporate directors may breach their fiduciary duty; they may also breach that duty by being grossly negligent or by wasting corporate assets”).

To survive a Rule 23.1 motion to dismiss in a due care case where an expert has advised the board in its decisionmaking process, the complaint must allege particularized facts (not conclusions) that, if proved, would show, for example, that: (a) the directors did not in fact rely on the expert; (b) their reliance was not in good faith; (c) they did not reasonably believe that the expert’s advice was within the expert’s professional competence; (d) the expert was not selected with reasonable care by or on behalf of the corporation, and the faulty selection process was attributable to the directors; (e) the subject matter (in this case the cost calculation) that was material and reasonably available was so obvious that the board’s failure to consider it was grossly negligent regardless of the expert’s advice or lack of advice; or (f) that the decision of the Board was so unconscionable as to constitute waste or fraud.

*Brehm v. Eisner*, 746 A.2d 244, 262 (Del. 2000).

<sup>75</sup> 473 A.2d 805 (Del. 1984).

<sup>76</sup> 488 A.2d 858 (Del. 1985).

<sup>77</sup> *In re Walt Disney Co. Derivative Litig.*, 900 A.2d 27 (Del. 2006). In this case, the plaintiff’s lawyer spent millions of dollars and lost the case. One explanation for why there are so few cases concerning the duty of care might be that most plaintiffs’ lawyers are unwilling to pay the same price while facing such a high risk of losing the case. See Geoffrey F. Miller, *A Modest Proposal for Fixing Delaware’s Broken Duty of Care*, 2010 COLUM. BUS. L. REV. 319, 325 (2011).

<sup>78</sup> *Firefighters’ Pension Sys. Tr. v. Presidio, Inc.*, 251 A.3d 212, 287 (Del. Ch. 2021); see also *Aronson*, 473 A.2d at 812 n.6 (using different descriptions to illustrate the connotation of gross negligence; “*Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 722 (Del. 1971), *rev’g*, 261 A.2d 911 (Del. Ch. 1969) (‘fraud or gross overreaching’); *Getty Oil Co. v. Skelly Oil Co.*, 267 A.2d 883, 887 (Del. 1970), *rev’g*, 255 A.2d 717 (Del. Ch. 1969) (‘gross and palpable overreaching’); *Warshaw v. Calhoun*, 221 A.2d 487, 492–93 (Del. 1966) (‘bad faith . . . or a gross abuse of discretion’); *Moskowitz v. Bantrell*, 190 A.2d 749, 750 (Del. 1963) (‘fraud or gross abuse of discretion’); *Kors v. Carey*, 158 A.2d 136, 140 (Del. Ch. 1960) (‘fraud, misconduct or abuse of discretion’)” (alteration in original); *Allaun v. Consolidated Oil Co.*, 147 A. 257, 261 (Del. Ch. 1929) (“reckless indifference to or a deliberate disregard of the stockholders”).

departure from the ordinary standard of care.”<sup>79</sup> More specifically, gross negligence shows “reckless indifference to or a deliberate disregard of the whole body of stockholders or actions which are without the bounds of reason.”<sup>80</sup> The court’s usage of the lenient standard of gross negligence as the standard for the duty of care, shows that the court deliberately under-enforces the duty of care. Courts’ rationale for setting such a deliberately deferential standard is not that it is the suitable standard in theory,<sup>81</sup> but that it is the same as setting the business judgment rule—giving both directors and courts a chance to make the wrong choice.<sup>82</sup>

### C. *The Future of the Duty of Care*

With continuous evolution over the last century, Delaware’s corporate law has put itself into a difficult situation because shareholders always lack adequate protection.<sup>83</sup> One scholar criticized Delaware’s corporate law, arguing that it “water[s] the rights of shareholders vis-à-vis management down to a thin gruel.”<sup>84</sup>

Between the fiduciary duties, the duty of loyalty should be stricter than the duty of care. However, the duty of loyalty has not played its due role in protecting minority shareholders. There are many opportunities for directors to exploit legal

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<sup>79</sup> *Browne v. Robb*, 583 A.2d 949, 953 (Del. 1990); *Firefighters’ Pension Sys. Tr. v. Presidio, Inc.*, 251 A.3d 287 (Del. Ch. 2021).

<sup>80</sup> *Zimmerman v. Crothall*, No. 6001-VCP, 2012 WL 707238, at \*8 (Del. Ch. Mar. 5, 2012), *as revised* (Mar. 27, 2012); *see also In re Walt Disney Co.*, 900 A.2d at 61 (stating that Disney directors “were informed of all information reasonably available and, thus, were not grossly negligent”).

<sup>81</sup> Velasco, *supra* note 67, at 647, 665 (stating that scholars do not think that gross negligence standard is “theoretically appropriate”).

<sup>82</sup> *Id.*; *see also Johnson, supra* note 54, at 819–20 (explaining the rationale for judicial deference of the business judgment rule); *In re Rural Metro Corp.*, 88 A.3d 54, 87 (Del. Ch. 2014) (illustrating that the economic reason behind these settings is that considering directors generally have little company ownership and incentive pay, that is, even if the decision-making brings benefits, they only get a very small portion). Rational directors will try to avoid risks because they may be punished by law when decision-making fails. *Id.* Directors choosing a low-risk plan is not what shareholders desire, because shareholders can divide their assets into multiple projects to reduce their total investment risk. *Id.* The way to deal with the gap between directors’ high risk and low return is to hold directors to a lower standard of responsibility through gross negligence, so that directors are willing to choose a high-risk plan, which is in line with the economic interests of shareholders. *Id.*

<sup>83</sup> *See Reza Dibadj, Disclosure as Delaware’s New Frontier*, 70 HASTINGS L.J. 689, 690 (2019).

<sup>84</sup> William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663, 666 (1974) (expressing the opinion that Delaware’s minority shareholders are vulnerable).

loopholes.<sup>85</sup> Delaware courts in the past decade preferred to assess whether the price is within the “measurable fair value range”<sup>86</sup> rather than whether the price is accurate and fair.<sup>87</sup> Therefore, the weakness of the duty of loyalty allows would-be defendants to fall through the cracks. This weakness requires the duty of care to tighten the loopholes so as to further regulate directors’ behavior.

Because the duty of loyalty has not been strictly implemented,<sup>88</sup> it is important to reinforce and reanimate the duty of care. Otherwise, the fiduciary duty will gradually wane. Once the fiduciary duty is obsolete, the interests of the company and shareholders, especially small and medium-sized shareholders, will be easily damaged. However, the duty of care has now become a formalistic obligation of examining only the related statistics in a fixed process for adequate time.<sup>89</sup> Directors may believe that the form of completing the duty of care task is far more important than the decision itself. Moreover, the divergence in standards of conduct and review entails that the directors’ breach of the duty of care in the majority of cases will only create liability for gross negligence.<sup>90</sup> However, it is difficult to prove that directors

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<sup>85</sup> *In re Oracle Corp. Derivative Litig.*, 824 A.2d 917, 938–39 (Del. Ch. 2003); *In re Oracle Corp. Derivative Litig.*, 824 A.2d 917, 938 (Del. Ch. 2003) (“Delaware law should not be based on a reductionist view of human nature that simplifies human motivations on the lines of the least sophisticated notions of the law and economics movement”) (citing from *Marchand v. Barnhill*, 212 A.3d 805, 818 (Del. 2019)).

<sup>86</sup> *DFC Global Corp. v. Muirfield Value Partners, L.P.*, 172 A.3d 346, 370 (2017) (Del. 2017)

A fair price does not mean the highest price financeable or the highest price that fiduciary could afford to pay. At least in the non-self-dealing context, it means a price that is one that a reasonable seller, under all of the circumstances, would regard as within a range of fair value; one that such a seller could reasonably accept.

Velasco, *supra* note 67, at 689 (articulating the standard of review for a fair price has become more forgiving).

<sup>87</sup> *Gottlieb v. Heyden Chem. Corp.*, 91 A.2d 57, 57–58 (Del. 1952) (“[Directors] themselves have assumed the burden of clearly proving their utmost good faith and the most scrupulous inherent fairness of the bargain”); *In re Orchard Enters., Inc. S’holder Litig.*, 88 A.3d 1, 49 (Del. Ch. 2014) (“The Supreme Court started by recognizing that ‘[u]nder settled principles, a parent corporation and its directors undertaking a short-form merger are self-dealing fiduciaries who should be required to establish entire fairness, including fair dealing and fair price.’”).

<sup>88</sup> See Julian Velasco, *The Diminishing Duty of Loyalty*, 75 WASH. & LEE L. REV. 1035, 1049 (2018) (illustrating the duty of loyalty’s defects).

<sup>89</sup> Stephen J. Lubben & Alana J. Darnell, *Delaware’s Duty of Care*, 31 DEL. J. CORP. L. 589, 591 (2006) (articulating how the classical duty of care with substantial significance vanishes).

<sup>90</sup> J. Travis Laster, *Fiduciary Duties in Activist Situations*, 13 VA. L. & BUS. REV. 75, 85 (2019).

have committed gross negligence and exculpation clauses may obviate directors' responsibility in the end.<sup>91</sup> Even if the plaintiff proves that the director's actions meet the standard of gross negligence, doing so just rebuts the business judgment rule presumption.<sup>92</sup> Rebutting the business judgment rule presumption does not trigger actual responsibility based on the fact that the director still has a chance to prove the entire fairness of the transaction.<sup>93</sup> The enabling statute, Delaware General Corporate Law ("DGCL") 102(b)(7),<sup>94</sup> allows corporations to exempt directors from personal liability for the breach of duty of care by adding an exculpatory provision in their charters.<sup>95</sup> This waiver provision further reduces the negligible risk that directors would be required to pay restitution to deter future infractions and adds one more layer of protection. Another disadvantage of 102(b)(7) is that shareholders may choose to take the initiative to file a lawsuit before the corporation's economic losses are caused by the board of directors' wrong decision, in order to avoid the exculpation clause's application.<sup>96</sup> This will lead to an increase in meaningless litigation and the waste of judicial resources. For corporations that do not opt-out of the duty of care in their charters, litigation for breach of directors' duty of care is

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<sup>91</sup> *Id.* ("[C]are has become relatively uninteresting, both because it is policed only for gross negligence, and because exculpation is available for breaches of the duty of care."); *see also* Assaf Hamdani & Reinier Kraakman, *Rewarding Outside Directors*, 105 MICH. L. REV. 1677, 1687 (2007) ("[D]irectors currently face very little risk of liability for negligent oversight.").

[T]he Delaware courts, using *Aronson* as their precedent, reduced the duty of care to a bare minimum. Not only was the bar of gross negligence hard to meet, the courts also shrank the duty of care to the requirement that directors be informed, a duty they could easily fulfil by following the script provided in *Van Gorkom*.

Dalia Tsuk Mitchell, *Status Bound: The Twentieth Century Evolution of Directors' Liability*, 5 N.Y.U. J.L. & BUS. 63, 146 (2009).

<sup>92</sup> *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 361 (Del. 1993).

<sup>93</sup> *Orman v. Cullman*, 794 A.2d 5, 21 n.36 (Del. Ch. 2002).

<sup>94</sup> DEL. CODE ANN. tit. 8, § 102(b)(7) (2020).

<sup>95</sup> DGCL plays an important role in Delaware's corporate governance and has become a reference statute for the formulation of company law in many countries in the world. The rationale behind the 102(b)(7) exemption is to attract capable people to serve as directors. Jonathan W. Groessl, *Delaware's New Section 102(b)(7): Boon or Bane for Corporate Directors?*, 37 DEPAUL L. REV. 411, 429–31 (1988); *A Critique of Van Gorkom*, *supra* note 52, at 462–63.

<sup>96</sup> Lubben & Damell, *supra* note 89, at 629 (discussing several useful ways to strengthen the duty of care).

likely to be settled,<sup>97</sup> and the company or the corporation itself may promise to indemnify directors for uninsured judgments. Therefore, the existence of both exculpatory clauses and the application of the business judgment rule results in few duty of care lawsuits being filed.<sup>98</sup> Most cases fail to provide useful proof at the stage of refuting the business judgment rule.<sup>99</sup> As a result, few plaintiffs will bring duty of care lawsuits, especially when the high litigation costs are not directly proportional to the little benefit they might receive, even if their claims are meritorious. These disincentives lead to almost no opportunity for courts to detail what is required for directors to meet their duty of care, especially in the current era when many new issues have emerged in corporate governance.

One applicable remedy in duty of care litigation is injunctive relief.<sup>100</sup> Commentators may argue that the duty of care still has limited vitality, because injunctive relief exists and is useful.<sup>101</sup> However, the application of injunctive relief is narrow because it is mostly used in merger cases.<sup>102</sup> Injunctive relief alone cannot meet the demands and effectively protect the interests of the majority of plaintiffs.

When directors violate both the duty of care and duty of loyalty, the plaintiff may only accuse the director of breaching the duty of loyalty because the director who violates the duty of care will often be shielded from personal liability.<sup>103</sup> Therefore, it seems meaningless for the plaintiff to prove that the defendant has violated the duty of care based on the fact that most courts will not even analyze whether the director's behavior is in line with the essence of the duty of care. When a judge is faced with a case in which both the duty of care and the duty of loyalty

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<sup>97</sup> See Bernard S. Black, *Is Corporate Law Trivial?: A Political and Economic Analysis*, 84 NW. U. L. REV. 542, 590 (1990) (“[M]ost cases are settled before the Supreme Court can hear them”).

<sup>98</sup> See J. Robert Brown, Jr., *The Irrelevance of State Corporate Law in Governance of Public Companies*, 38 U. RICH. L. REV. 317, 318–19 (2004).

<sup>99</sup> See J. Travis Laster, *Fiduciary Duties in Activist Situations*, 13 VA. L. & BUS. REV. 75, 99 (2019).

<sup>100</sup> *Police & Fire Ret. Sys. v. Bernal*, No. 4663–CC, 2009 WL 1873144, at \*3 (Del. Ch. June 26, 2009); see also Charles M. Elson & Robert B. Thompson, *Van Gorkom's Legacy: The Limits of Judicially Enforced Constraints and the Promise of Proprietary Incentives*, 96 NW. U. L. REV. 579, 584–85 (2002).

<sup>101</sup> Christopher A. Yeager, *At Least Somewhat Exaggerated: How Reports of the Death of Delaware's Duty of Care Don't Tell the Whole Story*, 103 GEO. L.J. 1387, 1402 (2015) (arguing that the duty of care is not a dead letter).

<sup>102</sup> See, e.g., *Police & Fire Ret. Sys. v. Bernal*, No. 4663–CC, 2009 WL 1873144, at \*3 (Del. Ch. June 26, 2009).

<sup>103</sup> Velasco, *supra* note 67, at 653 (“[E]ven cases that could have been successful under the duty of care might be re-characterized as duty of loyalty cases.”).

have a great chance of winning, the judge may prefer to make a judgment only based on the duty of loyalty that will not cause widespread public discussion because the judge may not want to be inconsistent with the judgment of the majority of courts that do not hold the duty of care enforceable.<sup>104</sup> Moreover, it is likely that the extremely rare duty of care based lawsuits will be settled or the plaintiff may dismiss their own claims,<sup>105</sup> making a director “statistically more likely to be attacked by killer bees than she is to have to ever pay damages for the breach of the duty of care.”<sup>106</sup> Through the listing of the above realities, we can find that the duty of care has gradually lost its role in regulating the behavior of directors. If no further measures are taken to restore the duty of care, it will only stay as a textbook law and will not serve as a powerful segment that protects the interests of shareholders especially those of minority shareholders.

With legislative changes to Delaware’s corporate law development, the primary objective has been “avoiding legislative change in the absence of clear and specific practical benefits.”<sup>107</sup> Thus, neither the Delaware legislatures nor the Delaware courts are willing to strengthen the constraints on the directors’ behavior based on amending statutory law or modifying case law.<sup>108</sup> The methods of strengthening the supervision of directors’ duty of care have become a topic worthy of attention under the condition that no major adjustment is made by Delaware courts.

### 1. Revitalizing the Duty of Care

The duty of care and the duty of loyalty should be mutually reinforcing and bolster each other. There should be no difference between the two in terms of contribution to corporate governance.<sup>109</sup> However, the probability of a director’s

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<sup>104</sup> *Id.* (“Each court may not want to be the outlier that finds liability under the duty of care when plaintiffs can be made whole under the less controversial duty of loyalty.”).

<sup>105</sup> *See, e.g.,* Laidlaw v. Acamar Partners Acquisition Corp. et al., Case No. 2021-0016-SG (Del. Ch. Jan. 7, 2021).

<sup>106</sup> *See* Lynn A. Stout, *On the Proper Motives for Corporate Directors (or, Why You Don’t Want to Invite Homo Economicus to Join Your Board)*, 28 DEL. J. CORP. L. 1, 7 (2003).

<sup>107</sup> *See* Lawrence A. Hamermesh, *The Policy Foundations of Delaware Corporate Law*, 106 COLUM. L. REV. 1749, 1752 (2006).

<sup>108</sup> *Id.*

<sup>109</sup> *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 367 (Del. 1993) (“Duty of care and duty of loyalty are the traditional hallmarks of a fiduciary who endeavors to act in the service of a corporation and its stockholders. Each of these duties is of equal and independent significance.”); *but see* Andrew Gold, *The Fiduciary Duty of Loyalty*, in *THE OXFORD HANDBOOK OF FIDUCIARY LAW* 386 (Evan J. Criddle, Paul B. Miller & Robert H. Sitkoff eds., 2019) (articulating that the fiduciary duty’s key point lies in the duty

breach of the duty of loyalty leading to real consequences is far higher than any consequences that may arise from a director's breach of the duty of care. Courts are also more concerned with the duty of loyalty than the duty of care, which may be partially due to the urgency of the duty of loyalty in the context of conflicts of interest. Therefore, it is necessary to design a better legal system so that the duty of care has more practical significance, not just in judicial sermonizing and educational functions.<sup>110</sup>

Although judges should not intervene excessively with corporate governance, courts should not avoid substantial supervision over the managerial decision-making process which is one of the core functions of directors.<sup>111</sup> Encouraging judges to write more opinions and analyses on whether the director's behavior is in line with the duty of care's requirement can effectively reduce the risks in corporate governance caused by the lax duty of care from both aspects of review and supervision of directors' conduct.<sup>112</sup> For example, the commentary in *Smith v. Van Gorkom* performs a guiding and warning role for all the directors.<sup>113</sup> One commentator describes that directors generally refuse to discuss the duty of care because they think this valueless concept wastes their time before the *Van Gorkom* decision; after *Van Gorkom*, "you were able to walk into a board room for the first time in my experience and really be heard."<sup>114</sup>

It might be difficult for judges who lack business experience and have no idea how to make decisions in the business world to distinguish between bad business decisions and "good business decisions that turn out badly."<sup>115</sup> However, few

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of loyalty); *but see* TAMAR FRANKEL, FIDUCIARY LAW 171 (2010) ("[T]he duty of care is not as weighty and prohibitory as the duty of loyalty.").

<sup>110</sup> *See, e.g.*, Edward B. Rock, *Saints and Sinners: How Does Delaware Corporate Law Work?*, 44 UCLA L. REV. 1009, 1016 (1997) (studying the pedagogical and educational function of the Delaware corporate law); *see also* Ethan J. Leib, David L. Ponet & Michael Serota, *Translating Fiduciary Principles into Public Law*, 126 HARV. L. REV. F. 91, 101 (2013) (arguing that courts tend to be "long on rhetoric precisely" instead of using "the stick").

<sup>111</sup> Delaware corporate law only reviews the decision-making process, and rarely examines the substance of business decisions.

<sup>112</sup> *See* Miller, *supra* note 77, at 327.

<sup>113</sup> 488 A.2d 858 (Del. 1985).

<sup>114</sup> Elson & Thompson, *supra* note 100, at 586 (citing *Roundtable: The Legacy of Smith v. Van Gorkom, DIRECTORS & BOARDS*, Spring 2000, at 37).

<sup>115</sup> *See A Critique of Van Gorkom, supra* note 52, at 660.

commentators believe that judges are not qualified to rule on medical cases without medical knowledge.<sup>116</sup> The uniqueness of the majority of business models makes it difficult for courts to find similar enterprises for valuable analogy analysis like medical cases.<sup>117</sup> Even if courts would like to seek the help of specialists in the business area, the low replicability of each corporation's specific situation makes it impossible for business specialists to help judges, unlike testifying doctors who can accurately evaluate the correctness of each step.<sup>118</sup>

Delaware judges have ruled on a large number of cases related to corporate governance for the past few decades, including landmark cases that can affect other countries' and regions' corporate law development. Delaware judges are proficient at examining problematic transactions such as mergers and acquisitions and reviewing evidence and records of the detailed decision-making process of the board of directors.<sup>119</sup> In addition, Delaware judges also have a bird's-eye view of business, as they deal with cases from various industries.<sup>120</sup> Even if courts lack sufficient expertise in reviewing the substantive merits of the business decision, the court's ability to review the decision-making process is sufficient because the review of procedural issues has objective standards, just like applying fixed mathematical formulas.

However, plaintiffs are likely to have a high chance of losing a breach of the duty of care claim due to the loose gross negligence standard. Moreover, judging whether a director is generally negligent or grossly negligent is related to factual issues, which are difficult to solve based solely on the complaint.<sup>121</sup> Litigation costs will become more expensive because of the necessarily protracted trial process, which might be not proportional to the potential benefits.<sup>122</sup> Therefore, almost no

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<sup>116</sup> See Holger Spamann, *Monetary Liability for Breach of the Duty of Care?*, 8 J. LEGAL ANALYSIS 337, 356–57 (2016).

<sup>117</sup> *Id.*

<sup>118</sup> *Id.* at 357 n.27 (explaining that courts have guidelines to evaluate the details of a surgeon's job step by step and they can also rely on other doctors' testimony, whereas the directors' behavior mode changes according to the business form, and there are no established instructions for courts to follow).

<sup>119</sup> See Miller, *supra* note 77, at 330 (articulating that Delaware judges' knowledge is not limited to knowing how to apply legal dogma and concepts from textbooks).

<sup>120</sup> *Id.* at 331.

<sup>121</sup> See Julian Velasco, *Structural Bias and the Need for Substantive Review*, 82 WASH. U. L.Q. 821, 885 (2004).

<sup>122</sup> See Spamann, *supra* note 116, at 354–55 (evaluating the litigation cost and opportunity cost).



plaintiff has filed a case merely based on the duty of care in recent years.<sup>123</sup> This explains why courts' latest views on the duty of care are unknown, making the duty of care rarely discussed and unable to be effectively developed and further evolved through new cases.<sup>124</sup> Thus, the court should consider how to encourage more shareholders to file a duty of care suit.

Trying to align standards of conduct with standards of review, "merging the soft law of corporate governance into the hard law of fiduciary duty," might be a part of the solution.<sup>125</sup> Lyman Johnson questioned the distinction between the standards of conduct and standards of review,<sup>126</sup> and suggested that "standards of review should be downplayed in fiduciary analysis."<sup>127</sup> The separation between the standard of conduct, the standard of review, and the gross negligence standard make the duty of care lose its real meaning, which allows the directors to conduct themselves according to the standard of review rather than the standard of care. At the same time, the dichotomy makes the judge's reasoning complicated.

Another suggestion is related to the Model Business Corporation Act ("MBCA"). In response to legislation mandating different standards for the duty of care in many states, the ABA's Committee on Corporate Laws added the uniform standard of care clause to the 1974 Amendment of the MBCA.<sup>128</sup> MBCA Section 8.30 stipulates that the standard of conduct of the director's duty of care is based on the care of "a person in a like position would reasonably believe appropriate under

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<sup>123</sup> There are only eleven cases on Westlaw concerning the director's duty of care in 2021, and nine in 2020. Of those few cases, most are not solely about the duty of care, but also about the duty of loyalty.

<sup>124</sup> Miller, *supra* note 77, at 329 (pointing out that since the vast majority of cases will be settled, and a limitation of the settlement agreements is that defendants do not confess their wrongdoings, it is impossible for the judge to write useful judicial comments).

<sup>125</sup> See Bratton, *supra* note 64, at 562 (expanding that the reason why Delaware courts believe that aligning the standards of conduct and review is unnecessary is that best practices have a fixed process in the decision-making structure, and strict responsibilities may reduce the enthusiasm of directors).

<sup>126</sup> See Lyman Johnson, *The Three Fiduciaries of Delaware Corporate Law—and Eisenberg's Error*, in FIDUCIARY OBLIGATIONS IN BUSINESS 57, 73 (Arthur B. Laby & Jacob Hale Russell eds., 2021) ("[S]tandards of review should be downplayed in fiduciary analysis."); see also Bratton, *supra* note 64, at 564 ("Eisenberg's description does not quite track the law as laid out in the cases.").

<sup>127</sup> Johnson, *supra* note 126, at, 73.

<sup>128</sup> See R. Franklin Balotti & Joseph IV Hinsey, *Director Care, Conduct, and Liability: The Model Business Corporation Act Solution*, 56 BUS. LAW. 35, 35–36, 40 (2000) (explaining the background and purpose of the introduction of the duty of care standard by the Committee on Corporate Laws).

similar circumstances.”<sup>129</sup> However, the official comment of Article 8.31, which described the standard of liability, stated that violating Article 8.30 is “necessary but not sufficient” to bear liability.<sup>130</sup> Future MBCA revisers can consider keeping Article 8.30 and Article 8.31 consistent rather than maintaining current differences. This deviation would result in directors demanding themselves with lower standards, thus affecting the effectiveness of the protection of shareholders’ interests by corporate law.

## 2. Liability of Directors for Negligence

From many cases, it can be concluded that the court is unwilling to hold directors responsible for a breach of duty of care.<sup>131</sup> The courts also enable the separation of the monetary liability from duty of care cases, which together results in the “evisceration” of the duty of care by failing to meet shareholders’ needs.<sup>132</sup> In order to make up for the lack of duty of care, Delaware courts upgraded the duty of

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<sup>129</sup> Standards of Conduct for Directors:

(a) Each member of the board of directors, when discharging the duties of a director, shall act: (i) in good faith, and (ii) in a manner the director reasonably believes to be in the best interests of the corporation.

(b) The members of the board of directors or a board committee, when becoming informed in connection with their decision-making function or devoting attention to their oversight function, shall discharge their duties with the care that a person in a like position would reasonably believe appropriate under similar circumstances.

MODEL BUS. CORP. ACT § 8.30 (AM. BAR ASS’N 2021). The 1998 amendment revised the 1974 expression which is controversial because it is similar to tort law, that is, “an ordinarily prudent person in a like position would exercise.” See Balotti & Hinsey, *supra* note 128, at 50 (introducing section 8.30’s 1998 revision).

<sup>130</sup> See Edward Rock & Michael Wachter, *Dangerous Liaisons: Corporate Law, Trust Law, and Interdoctrinal Legal Transplants*, 96 NW. U. L. REV. 651, 662–63 (2002) (tracing the development of the duty of care in MBCA); MODEL BUS CORP. ACT ANN. § 8.31, official cmt. (2020) (“[T]he fact that a director’s performance fails to meet the standards of section 8.30 does not in itself establish personal liability for damages that the corporation or its shareholders may have suffered as a consequence.”).

<sup>131</sup> See, e.g., *In re Citigroup Inc. S’holder Derivative Litig.*, 964 A.2d 106, 130 (Del. Ch. 2009) (illustrating that the Delaware courts generally will not hold directors responsible when the interests of the company are seriously damaged by the directors’ bad strategy).

<sup>132</sup> Velasco, *supra* note 67, at 701 (elaborating the reasons why simplifying fiduciary duties will not achieve desired results). The reason why courts are unwilling to hold directors monetarily liable for the duty of care claims is that directors’ wrong decisions may lead to compensation of millions of dollars, which is much higher than their income, inhibiting their enthusiasm for decision-making. *Id.* at 655; see also Marc I. Steinberg, *The Evisceration of the Duty of Care*, 42 SW. L.J. 919, 929 (1989).

care claim to new terms: good faith and bad faith.<sup>133</sup> There are a few rare cases where the Delaware courts might consider directors' liability, including when the shareholders can prove the directors engaged in bad faith conduct or that there exists an unreasonable decision-making process that can reach the high bar of the waste claim.<sup>134</sup> Plaintiffs have to "plead particularized facts showing bad faith in order to establish a substantial likelihood of personal directorial liability."<sup>135</sup> The Delaware courts' effort to strengthen the fiduciary duty is to some extent reflected in their frequent analysis under *Caremark* liability.<sup>136</sup> Thus, in reanimating the duty of care, one may require the study of concepts related to the duty of good faith for inspiration.<sup>137</sup>

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<sup>133</sup> Velasco, *supra* note 67, at 701 ("Over time, the specter of the Van Gorkom decision receded, and the need for a duty of care grew. At the continual prodding of shareholder plaintiffs, the Delaware courts eventually relented and allowed duty of care claims to be recast as duty of good faith claims in *Disney* and *Stone v. Ritter*. The significance of this development cannot be overstated: because good faith claims cannot be excused, damages based on carelessness became a possibility once more.").

<sup>134</sup> *In re Citigroup Inc. S'holder Derivative Litig.*, 964 A.2d 106, 130 (Del. Ch. 2009). The *Caremark* court also illustrated the duty of good faith; it said that "only a sustained or systematic failure of the board to exercise oversight—such as an utter failure to attempt to assure a reasonable information and reporting system exists—will establish the lack of good faith that is a necessary condition to liability." *In re Caremark Intern. Inc. Derivative Litig.*, 698 A.2d 959, 971 (Del. Ch. 1996).

<sup>135</sup> *In re Dow Chem. Co. Derivative Litig.*, No. 4349-CC, 2010 WL 66769, \*1, 12 (Del Ch. Jan. 11, 2010).

<sup>136</sup> *In re Boeing Co. Derivative Litig.*, No. 2019-0907-MTZ, 2021 WL 4059934 (Del. Ch. Sept. 7, 2021); *Teamsters Local 443 Health Servs. & Ins. Plan v. Chou*, No. 2019-0816-SG, 2020 WL 5028065 (Del. Ch. Aug. 24, 2020); *In re Clovis Oncology, Inc. Derivative Litig.*, No. 2017-0222-JRS, 2019 WL 4850188 (Del. Ch. Oct. 1, 2019). To be clear, the *Caremark* court placed the monitor duty under the duty of care. However, later cases such as *Guttman v. Huang*, 823 A.2d 492 (Del. Ch. 2003), regarded the *Caremark* responsibility as part of the duty of loyalty. The rationale behind this arrangement might be that Delaware courts want to draw a clear line between the following two situations. Negligent directors do not need to bear responsibility, but directors cannot be excused from personal liability by using 102(b)(7) if they violate the *Caremark* obligation. See *In re Caremark*, 698 A.2d 959; *Guttman*, 823 A.2d at 506 ("Although the *Caremark* decision is rightly seen as a prod towards the greater exercise of care by directors in monitoring their corporations' compliance with legal standards, by its plain and intentional terms, the opinion articulates a standard for liability for failures of oversight that requires a showing that the directors breached their duty of loyalty by failing to attend to their duties in good faith."); see also Stephen M. Bainbridge et al., *The Convergence of Good Faith and Oversight*, 55 UCLA L. REV. 559, 595–97 (2008); Mark J. Loewenstein, *The Diverging Meaning of Good Faith*, 34 DEL. J. CORP. L. 433, 445 (2009) (clarifying that courts can avoid the article 102(b)(7) exemption from liability of directors for breach of duty of care by attributing the oversight duty to the jurisdiction of the duty of loyalty); Miller & Gold, *supra* note 73, at 557–58 ("This conception of loyalty as pertaining to motive or subjective purpose is especially prominent in Delaware corporate law, where the duty of good faith has been incorporated into that of loyalty.").

<sup>137</sup> The background of duty of good faith is based on the Enron scandal, which led Congress to realize that statutes like DGCL 102(b)(7) could make directors who violate the duty of care evade their

Compared with the duty of care, bad faith focuses more on directors' "subjective bad motive or intent."<sup>138</sup> Gross negligence which includes "a failure to inform one's self of available material facts" cannot be regarded as bad faith.<sup>139</sup> The Delaware Supreme Court held that the confusion of duty of care and good faith will result in the infraction of the duty of care becoming a breach of good faith, which will lead to the invalidity of the protection of directors' breach of duty of care.<sup>140</sup> Therefore, the Delaware court separates bad faith behavior from breaching duty of care by the fact that directors who committed bad faith could not be exempted from monetary compensation through DGCL § 102(b)(7).<sup>141</sup>

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responsibilities. As a result, Congress formulated new rules to make up for Delaware's loose corporate law. The Delaware court worried that the federal intervention might endanger their leading position in corporate governance, setting up the duty of good faith to prevent serious violations of the duty of care become an appropriate choice. See Renee M. Jones, *The Role of Good Faith in Delaware: How Open-Ended Standards Help Delaware Preserve Its Edge*, 55 N.Y. L. SCH. L. REV. 499, 502, 505-06 (2010); see also Robert B. Thompson, *The Short, but Interesting Life of Good Faith as an Independent Liability Rule*, 55 N.Y. L. SCH. L. REV. 543, 544, 548 (2010) (revealing why the Delaware court set up the duty of good faith).

<sup>138</sup> *In re Walt Disney Co. Derivative Litig.*, 906 A.2d 27, 62 (Del. 2006) (discussing the differences between the duty of care and duty of good faith); see also *In re Walt Disney Co. Derivative Litig.*, 907 A.2d 693, 755 (Del. Ch. 2005) ("[T]he concept of intentional dereliction of duty, a conscious disregard for one's responsibilities, is an appropriate (although not the only) standard for determining whether fiduciaries have acted in good faith. Deliberate indifference and inaction in the face of a duty to act is, in my mind, conduct that is clearly disloyal to the corporation. It is the epitome of faithless conduct.") (emphasis omitted) (footnote omitted).

<sup>139</sup> *In re Walt Disney Co.*, 906 A.2d at 64-65.

<sup>140</sup> *Id.* at 66.

<sup>141</sup> *Id.* at 65-66; DEL. CODE ANN. tit. 8, § 102 (b)(7). Delaware Code Title 8, Corporations § 145 also stated that a corporation has the power to reimburse directors who breached the duty of care but shall not compensate the directors who showed bad faith. *Id.* at § 145(a)-(b).

- (a) A corporation shall have power to indemnify any person who was or is a party or is threatened to be made a party to any threatened, pending or completed action, suit or proceeding, whether civil, criminal, administrative or investigative (other than an action by or in the right of the corporation) by reason of the fact that the person is or was a director, officer, employee or agent of the corporation, or is or was serving at the request of the corporation as a director, officer, employee or agent of another corporation, partnership, joint venture, trust or other enterprise, against expenses (including attorneys' fees), judgments, fines and amounts paid in settlement actually and reasonably incurred by the person in connection with such action, suit or proceeding if the person acted in good faith and in a manner the person reasonably believed to be in or not opposed to the best interests of the corporation, and, with

One commentator argues that the most appropriate responsibility imposed on the duty of care should not be “full liability.”<sup>142</sup> If derivative litigation always leads to settlement,<sup>143</sup> then the company or the liability insurance company instead of directors may have to pay high fees in order to encourage directors to continue investing themselves in the business venture.<sup>144</sup> The company paying full compensation is not conducive to guiding the behavior of directors to comply with the duty of care, because the worst result of violating the duty of care is only damaging to their reputation under this scenario.<sup>145</sup> Requiring noncompliant directors to take full personal liability is not the best choice because the huge amount of penalty might deter potentially talented directors from taking up directorship. However, this does not mean that directors should take no responsibility for acts that

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respect to any criminal action or proceeding, had no reasonable cause to believe the person’s conduct was unlawful.

- (b) A corporation shall have power to indemnify any person who was or is a party or is threatened to be made a party to any threatened, pending or completed action or suit by or in the right of the corporation to procure a judgment in its favor by reason of the fact that the person is or was a director, officer, employee or agent of the corporation, or is or was serving at the request of the corporation as a director, officer, employee or agent of another corporation, partnership, joint venture, trust or other enterprise against expenses (including attorneys’ fees) actually and reasonably incurred by the person in connection with the defense or settlement of such action or suit if the person acted in good faith and in a manner the person reasonably believed to be in or not opposed to the best interests of the corporation and except that no indemnification shall be made in respect of any claim, issue or matter as to which such person shall have been adjudged to be liable to the corporation unless and only to the extent that the Court of Chancery or the court in which such action or suit was brought shall determine upon application that, despite the adjudication of liability but in view of all the circumstances of the case, such person is fairly and reasonably entitled to indemnity for such expenses which the Court of Chancery or such other court shall deem proper.

*Id.*

<sup>142</sup> See Spamann, *supra* note 116, at 359 (recognizing that allowing the directors in poor governance entities to take the responsibility may have a good effect).

<sup>143</sup> See John C. Coffee, Jr., *Litigation and Corporate Governance: An Essay on Steering Between Scylla and Charybdis*, 52 GEO. WASH. L. REV. 789, 796 (1984).

<sup>144</sup> Corporations may pay the compensation for directors based on the indemnification agreements and directors will acknowledge no fault. Spamann, *supra* note 116, at 356 (citation omitted).

<sup>145</sup> Spamann, *supra* note 116, at 356.

fail to fulfill their duty of care. It is necessary to ensure that such punitive damages can only be paid if the defendant's directors also pay. Directors who violate the duty of care should be required to pay a small portion of the expenses for the acts of gross negligence, thereby potentially placing the directors' personal assets at risk. Each of these measures will constitute an improvement to "the broken duty of care."<sup>146</sup>

### 3. Who Should Bear the Burden of Proof?

The key to winning the lawsuit is not what the plaintiffs' accusations are, but ultimately what both parties can prove in the end. Delaware corporate law presumes that directors make business decisions "on an informed basis, in good faith, and in the honest belief that the action taken was in the best interests of the company."<sup>147</sup> In order to rebut the presumption, the plaintiff "must first plead and later prove to prevail."<sup>148</sup> If the plaintiff established facts that the board acted in gross negligence or that the board's decision was uninformed to rebut the presumption, then the defendant needs to show that "the challenged transaction was 'entirely fair' to the shareholder plaintiff."<sup>149</sup>

However, letting the plaintiff carry the burden of proof might increase the loss rate of the case because the plaintiff does not participate in the daily operation of the company. In Germany, ordinary negligence leads to the director's liability for compensation to the company;<sup>150</sup> German directors need to prove that their action does not constitute negligence in order to be exempted.<sup>151</sup> The United States

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<sup>146</sup> See Miller, *supra* note 77, at 335.

<sup>147</sup> Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984).

<sup>148</sup> *In re Trados Inc. S'holder Litig.* (Trados II), 73 A.3d 17, 36 (Del. Ch. 2013); see also Aronson, 473 A.2d at 812; *Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1156, 1162 (Del. 1995); *In re Walt Disney Co. Derivative Litig.*, 900 A.2d 27, 52 (Del. 2006); see also MODEL BUS CORP. ACT ANN. § 8.31(b) (AM. BAR ASS'N 2016).

<sup>149</sup> *Emerald Partners v. Berlin*, 787 A.2d 85, 91 (Del. 2001); see also *Brehm v. Eisner*, 746 A.2d 244, 264 n.66 (Del. 2000) ("Thus, directors' decisions will be respected by courts unless the directors are interested or lack independence relative to the decision, do not act in good faith, act in a manner that cannot be attributed to a rational business purpose or reach their decision by a grossly negligent process that includes the failure to consider all material facts reasonably available.").

<sup>150</sup> Gerhard Wagner, *Officers' and Directors' Liability under German Law—A Potemkin Village*, 16 THEORETICAL INQUIRES L. 69, 69 (2015).

<sup>151</sup> *Id.*; see Leon Yehuda Anidjar, *Directors' Duty of Care in Times of Financial Distress following the Global Pandemic Crisis*, 46 BROOK. J. INT'L L. 99, 124 (2020).

(2) Members of the management board who violate their duties shall be jointly and severally liable to the company for any resulting damage. They shall bear the burden of proof in the event of a dispute as to whether they have employed

corporate governance field could learn from the German model. The Delaware court has already reversed the burden of proof in hostile takeover cases,<sup>152</sup> and this method should be extended to more general cases.

### III. IMPLICATIONS FOR CHINA

After a thorough study of the standard of duty of care in the Delaware courts, the Chinese Company Law drafting committee can adopt the effective concepts of the U.S. duty of care framework to improve the integrity of Chinese directors' duty of care and strengthen the protection of Chinese shareholders. However, China should not adopt America's deferential standard of review, which renders the duty of care useless.

#### A. *Legal Transplantation*

Because the basic concepts, theories, composition, structure, and doctrines of the duty of care are similar in the civil law and common law systems, the legal content transplanted through lower economic cost can be easily accepted by another country. However, corporate law is easily influenced by the economic concept of the host country. The American free-market economy allows for corporate law to encourage innovation and focuses on avoiding the discouragement of any director's enthusiasm. Therefore, direct transplantation without modification may not meet the needs of derivative litigation in another country.<sup>153</sup> Judicial provisions transplanted without modification may lead to plaintiffs not using the clause as a cause of action, the judges failing to interpret the law well, or may even reduce the shareholders' confidence in the legal system. In order to achieve the expected results of legal transplantation such as optimizing corporate governance, it is necessary to make appropriate adjustments to the introduced laws and formulate a plan that can truly

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the care of a diligent and conscientious manager. If the company takes out insurance covering the risks of a member of the managing board arising from his work for the company, such insurance should provide for a deductible of no less than 10 percent of the damage up to at least an amount equal to 1.5 times the fixed annual compensation of the managing board member.

Aktiengesetz [AktG] [Stock Corporation Act], September 6, 1965, BGBl. I at 1089) § 93(2) (Ger.).

<sup>152</sup> *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 955 (Del. 1985).

<sup>153</sup> See Lynn A. Stout, *On the Export of U.S.-Style Corporate Fiduciary Duties to Other Cultures: Can a Transplant Take?*, in *GLOBAL MARKETS, DOMESTIC INSTITUTIONS: CORPORATE LAW AND GOVERNANCE IN A NEW ERA OF CROSS-BORDER DEALS* 46, 47 (Curtis J. Milhaupt ed., 2003) (illustrating how the result of legal term's transplantation would be influenced by host country's local conditions).

solve the problems of China's corporate governance development and meet Chinese shareholders' practical needs.<sup>154</sup>

The Anglo-American fiduciary duty is defined by evolving case law in common law countries,<sup>155</sup> which means that the duty of care's standards is constituted by cases' commentary. In China, precedents only play an auxiliary role, and clear rules and statutes are the primary sources of the standards of duty of care.<sup>156</sup> The problem with transplantation is that the transported and codified duty of care is not able to cover all the contents of the U.S.'s duty of care.<sup>157</sup> The result of hasty transplantation might be that concepts taken out of context are mechanically applied to cases with different backgrounds. The judges in the transplant country may only understand and use only the literal meaning of original concepts and doctrines, thereby ignoring its flexible application and its deep evolution. The evolving case law in the origin country provides useful examples that judges can look back at to conduct a comparison. In the actual trial of a case, the judge can compare the current case with a previous case of violation of due care or compare it with another case that did not violate the duty. It is hard to capture all these detailed and vivid examples into the codified statute. Therefore, the U.S. duty of care standard should not be transplanted literally but can be generally accepted based on its underlying principles.

Another difference that deserves special attention when considering which criteria China should choose is that Delaware's duty of care is based on common law. One of the advantages of common law is that judges can change the law at any time according to the facts of the present case and the novel situations it may present. Therefore, Delaware's corporate law can constantly explore and try different standards in the cases, thereby developing the duty of care. In recent years, Delaware's duty of care has become static and marginalized. To a large extent, the

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<sup>154</sup> See Hideki Kanda & Curtis J. Milhaupt, *Re-examining Legal Transplants: The Director's Fiduciary Duty to Japanese Corporate Law*, 51 AM. J. COMPAR. L. 887, 891 (2003) (proposing that "fit" can be considered to have two parts: micro and macro. Micro-fit refers to the extent to which the transplanted laws fit the host country's legal basis. A macro-fit index can detect whether the introduced laws are in harmony with the existing economic system).

<sup>155</sup> See Jiangyu Wang, *Enforcing Fiduciary Duties as Tort Liability in Chinese Courts*, in ENFORCEMENT OF CORPORATE AND SECURITIES LAW: CHINA AND THE WORLD 185, 186 (Robin Hui Huang & Nicholas Calcina Howson eds., 2017).

<sup>156</sup> Jianbin Wu (吴建斌), *Gongsijiufen Zhidaoxinganli De Xiaolidingwei* (公司纠纷指导性案例的效力定位) [The Effectiveness of Corporate Disputes' Guiding Cases], FA XUE (法学) [LAW SCIENCE] 54, 56 (2015).

<sup>157</sup> See Wang, *supra* note 155, at 203.



duty of care only plays an educational role. China is a civil law country, and it is unrealistic to change laws frequently. It takes a long time to revise a code of law because the procedures are complicated, including scholars' discussions and judicial departments' proposals, and the People's Congress' vote. Many judges at the lower-level courts have heavy workloads and they are not able to spend significant time analyzing the reasons for a judgment in detail.<sup>158</sup> Given that courts' judicial reasoning is not sufficient, stipulating a clear, uncomplicated and operable standard is needed. A specific standard, supplemented by judicial interpretation and guiding cases, can constitute a complete law that can guide directors' behavior.

### B. *A Proposal to Amend Chinese Corporate Law*

#### 1. Which Standard to Choose?

After successful transplantation, the directors' duty of care standards can provide useful legal support for shareholders, especially minority shareholders, to safeguard their rights. However, derivative lawsuits, like the duty of care, have only been introduced in China for just more than a decade.<sup>159</sup> Most shareholders, especially minority shareholders, are not aware of how to file a shareholder derivative suit,<sup>160</sup> which has prevented shareholder derivative litigation from reaching the stage of vigorous development<sup>161</sup> and not playing a role in promoting the development of directors' duty of care to a great extent. This is caused by the different corporate governance models of China and the United States. In contrast to

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<sup>158</sup> Xulong Zhuang (庄绪龙), *Caipanwenshu Shuolinan De Xianshiyujing Yu Zhidulixing (裁判文书"说理难"的现实语境与制度理性)* [Realistic Context and Institutional Rationality of "Difficult Reasoning" in Judicial Documents], *FALV SHIYONG (法律适用)* [JOURNAL OF LAW APPLICATION] 83, 86 (2015).

<sup>159</sup> Zhu, *supra* note 44, at 95 (introducing that the revision of China's company law in 2005 made concrete efforts to improve corporate governance).

<sup>160</sup> Xiaoxiao Peng (彭晓晓), *Woguo Gudongpaishengsusongzhidu Yanjiu (我国股东派生诉讼制度研究)* [Study on China's Shareholder Derivative Action System], *HEBEI FAXUE (河北法学)* [HEBEI LAW SCIENCE] 150, 152 (2011).

<sup>161</sup> Shaowei Lin (林少伟), *Paishengsusong Heyikeneng: Fansi Yu Chaoyue—Yi Riben Paishengsusong De Fazhan Wei Chufadian (派生诉讼何以可能:反思与超越—以日本派生诉讼的发展为出发点)* [How Could Derivative Actions be Possible: Reflection and Transcendence—In view of the Development of Japanese Derivative System], *BEIFANG FAXUE (北方法学)* [NORTHERN LEGAL SCIENCE] 100, 100 (2017); *but see* Robin Hui Huang, *Shareholder Derivative Litigation in China: Empirical Findings and Comparative Analysis*, 27(4) *BANKING AND FINANCE LAW REVIEW* 619, 628 (2012) (arguing that there are quite a few derivative actions in China compared to the number of cases in other countries at the initial stage of introducing derivative litigation, and there were around 50 cases in China at the first five years of introducing the derivative litigation system, while Australia has 31 lawsuits at the same stage, and Japan has even fewer derivative lawsuits).

many American corporate governance structures, internal corporate governance disputes in China often manifest as investment disputes or equity transfer disputes rather than as the directors' duty disputes in American derivative litigation.<sup>162</sup> This difference stems from the fact that American stockholders tend to cede much of the corporation's management responsibilities to the directors. However, the majority of Chinese stockholders in close corporations directly participate in the daily management of the corporation,<sup>163</sup> and the controlling shareholders of some listed companies with concentrated equity participation in the daily management of the company by appointing directors.<sup>164</sup> The representative of state investors of state-controlled listed companies might serve as the board chairman and participate in the operation of the corporation.<sup>165</sup> American shareholders' participation in corporate governance is mostly reflected in the vote for directors and the ability to restrict the rights of directors.<sup>166</sup> An important part of directors' duty of care is that directors should fulfill "a reasonable decision-making process" and "make reasonable decisions."<sup>167</sup> The impact of shareholders' participation in corporations' daily operations on directors' duty of care is reflected in the fact that shareholders may not consider CSR and ESG in decision-making for the sake of the companies' profits due to the lack of professionalism. On the surface, it seems that the professional directors may have violated the duty of care because they did not consider all factors before making decisions. The truth is that shareholders might affect the long-term

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<sup>162</sup> See, e.g., Wangfan deng Yu Liuyapeng Sunhaigongsiliyizerenjiufen An (王凡等与刘亚鹏损害公司利益责任纠纷案) [Wangfan V. Liuyapeng], Beijing Second Inter. Peoples' Ct. No. 2890 (Sept. 3, 2020) (Without the resolution of the shareholders' meeting, Wang transferred the company's equity to others. The court held that he failed to fulfill his duty of care.); Wang, *supra* note 15, at 27.

<sup>163</sup> See Tiantao Shi (施天涛), Jing Du (杜晶), Woguogongsifa Shang Guanlianjiaoyi De Guiyi Jiqi Falvguizhi—Yige Liyichongtujiaoyifaze De Zhongguobanben (我国公司法上关联交易的皈依及其法律规制——一个利益冲突交易法则的中国版本) [The Conversion of related party transactions in China's company law and its legal regulation—a Chinese Copy of Rules on Deal of Interests Conflicts], ZHONGGUO FAXUE (中国法学) [CHINA LEGAL SCIENCE] 126, 138 (2007).

<sup>164</sup> Shaowei Lin (林少伟), Dongshiyizhihua Dui Chuantongdongshiyiwuguize DeChongji Jiqifalvyingdui Yi Daibiaodongshi Wei Yanjiushijiao (董事异质化对传统董事义务规则的冲击及其法律应对——以代表董事为研究视角) [The Impact of Director Heterogeneity on the Traditional Rules of Directors' Duties and Its Legal Implications From the Perspective of Representative Directors], ZHONGWAI FAXUE (中外法学) [PEKING UNIVERSITY LAW JOURNAL] 665, 669 (2015).

<sup>165</sup> See, e.g., Chengli Du (杜成立), Guanyu Jinyibu Wanshan Gongsifarenzhilijiegou De Sikao (关于进一步完善公司法人治理结构的思考) [Thoughts on further improving the corporate governance structure], QIU SHI (求实) [TRUTH SEEKING] 114, 115 (2006).

<sup>166</sup> D'Onfro, *supra* note 42, at 16.

<sup>167</sup> Eisenberg, *supra* note 7, at 948 (1990).

interests of the company by manipulating directors. Because the equity of many listed companies in China is concentrated with the controlling shareholders who elect directors, and directors make decisions according to the wishes of the controlling shareholders.<sup>168</sup> Thus, Chinese judges should fully understand the actual situation of the directors' decision-making process, such as the role of the person who actually makes the decision of the board of directors and the real situation faced by directors at that time.

After a thorough understanding of the unique characteristics of China's corporate governance, we will find that even if a case is filed based on a breach of fiduciary duty, it may still essentially be an intra-shareholder dispute and shareholders might only use fiduciary duty as a cause for a suit.<sup>169</sup> Therefore, it is particularly important to have a clear standard to guide the court, especially for those cases where the apparent cause of action is not necessarily the real cause of action.

There are only 4,839 publicly listed companies in mainland China,<sup>170</sup> and 2.39 million limited liability companies in China,<sup>171</sup> and the listed companies are also subject to the supervision of China's Securities Regulatory Commission. Most of the litigation of duty of care in China involves limited liability companies,<sup>172</sup> which might lack high-level professional management. It is difficult to require these directors who work for small and medium-sized enterprises to be elites and fully

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<sup>168</sup> See Jun Zhao (赵骏), *Dongshi Qinmiyaniwu Yanjiu: Cong Yuwailun Dao Zhongguoshijian—Yi Xingweifajingixue Wei Shijiao* (董事勤勉义务研究: 从域外理论到中国实践—以行为法经济学为视角) [Research on Directors' duty of care: from foreign theory to Chinese practice—from the perspective of behavioral law economics], *ZHEJIANG XUE KAN* (浙江学刊) [ZHEJIANG ACADEMIC JOURNAL] 135, 136–37 (2013); see also Xudong Zhao (赵旭东), *Gongsizhili Zhong de Konggugudong Jiqi Falvguizhi* (公司治理中的控股股东及其法律规制) [Controlling Shareholder and its Legal Regulation in Corporate Governance], *FAXUE YANJIU* (法学研究) [CHINESE JOURNAL OF LAW] 92, 96–97 (2020).

<sup>169</sup> Wang, *supra* note 15, at 27.

<sup>170</sup> Shanghai Stock Exchange: <http://www.sse.com.cn/market/stockdata/statistic/> (visited on June 8, 2022) (showing that there are 2,100 listed corporations on Shanghai Stock Exchange); Shenzhen Stock Exchange: <http://www.szse.cn/market/index.html> (visited on June 8, 2022) (showing that there are 2,645 listed corporations in Shenzhen Stock Exchange); Beijing Stock Exchange: <http://www.bse.cn/static/statisticdata.html> (visited on June 8, 2022) (showing that the Beijing Stock Exchange has 94 listed corporations since its opening in 2021).

<sup>171</sup> An Dengjizhuceleixing Fenzu De Farendanweishu Ji Renyuanshu (按登记注册类型分组的法人单位数及从业人数) [Number of Legal Entities and Employees Classified by Registration Type], *Zhongguo Jingji Pucha Nianjian* (中国经济普查年鉴) [CHINA ECONOMIC CENSUS YEARBOOK] (Jan. 6, 2018), <http://www.stats.gov.cn/tjsj/pcsj/fjpc/4jp/zk/indexch.htm>.

<sup>172</sup> Wang, *supra* note 15, at 24.

understand many other industries at a high level. However, the loose standard of gross negligence and the divergence between the standards of conduct and review may make the duty of care become a dead letter and allow unqualified people to act as “Vase Directors.” “Vase Directors”<sup>173</sup> is a Chinese expression for directors who do not actively participate in the management of the company.<sup>174</sup> Vase Directors only go through the fixed process and sign documents, which makes the duty of care rigid and formalized, but does not achieve substantive results.<sup>175</sup> The most ideal state is that directors actively care about the company and may even find problems that need to be solved in the process of performing their duties, so as to substantially help the long-term development of the company. Vase director is similar to the American term “rubber stamp”—a director who does not actually voice his own opinions but who simply “rubber stamps” the decisions of the other directors.<sup>176</sup> A more specific scenario is as follows: “Literally, half the board is dozing off. The other half is reading the Wall Street Journal. And then they put slides up a lot and nobody can understand the slides and when it gets dark they all doze off.”<sup>177</sup> Therefore, all these standards mentioned above are not suitable for the current situation of corporate governance in China.

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<sup>173</sup> See, e.g., Tingting Zhang (张婷婷), *Dulidongshiqinmianyiwu De Bianjie Yu Zhuizebiaozhun—Jiyu 15 Jian Dulidongshi Weijin Qinmianyiwu Xingzhengchufa An De Fenxi* (独立董事勤勉义务的边界与追责标准—基于 15 件独立董事未尽勤勉义务行政处罚案的分析) [The Boundary of Independent Directors' Duty of Care and the Criterion for Liability: Analysis Based on 15 Administrative Case for Non-Performance of Duty of Care], *FALV SHIYONG* (法律适用) [JOURNAL OF LAW APPLICATION] 84, 86, 96 (2020); Junhai Liu (刘俊海), *Shangshigongsi Dulidongshi Zhidu De Fansi He Chongggou—Kangmeiyaoye An Zhong Dudong Jueliandaipeichangzeren De Falvsikao* (上市公司独立董事制度的反思和重构——康美药业案中独董巨额连带赔偿责任的法律思考) [Reflection and Reconstruction of the Independent Director System of Listed Companies: Legal Consideration on the Huge Joint and Several Liability of the Independent Directors in Kangmei Pharmaceutical Case], *FAXUE ZAZHI* (法学杂志) [LAW SCIENCE MAGAZINE] 1, 2, 17, 23, 25 (2022).

<sup>174</sup> Jie Yuan, *Formal Convergence or Substantial Divergence? Evidence from Adoption of the Independent Director System in China*, 9 *ASIAN-PACIFIC L. POL'Y J.* 71, 89 (2007).

<sup>175</sup> Similar problems arise in the implementation of many laws. See, e.g., Waldman, *supra* note 42, at 786 (observing that the implementation of privacy law has become a compliance checklist in practice, resulting in formality being greater than materiality).

<sup>176</sup> See, e.g., Kevin LaCroix, *SPAC-Related Class Action Breach of Fiduciary Duty Lawsuit Filed in Delaware Chancery Court*, *THE D&O DIARY* (Aug. 9, 2021), <https://www.dandodiary.com/2021/08/articles/director-and-officer-liability/spac-related-class-action-breach-of-fiduciary-duty-lawsuit-filed-in-delaware-chancery-court/> [https://perma.cc/L7EG-GHQT].

<sup>177</sup> *Asleep in the Boardroom*, *WASH. POST* (May 23, 2002), <https://www.washingtonpost.com/archive/opinions/2002/05/23/asleep-in-the-boardroom/7659322e-e216-48aa-9821-956e7aa34b31/> [https://perma.cc/82K8-TCW7].

This Article proposes that the review standard of the duty of care in Chinese Company Law should be determined depending on prior offenses and apply stricter standards to recidivism. Chinese Company Law should distinguish between directors who have violated the duty of care in the past and directors who have never violated the duty of care before. Violation of duty of care includes, but is not limited to, the fact that the board of directors may not be able to properly inform themselves about corporations' operation and management, or a proposed action before making a decision. As long as the plaintiff of this case or other cases has successfully proved that a director has violated the duty of care, or shareholders have not directly brought a lawsuit, but corporations recorded the recognized damage caused by the directors' violation of the duty of care, these all belong to a historical record of the violation of the duty of care. Article 147 of the Chinese Company Law should stipulate that if the director has any history of violating the duty of care, then ordinary negligence is applicable. If the director violates the duty of care for the first time, gross negligence is applicable.

There are similar precedents regarding violation times in other U.S. laws. For example, the FTC will not impose fines on companies that do not comply with the FTC's core requirements such as unfair and deceptive practices for the first time.<sup>178</sup> In addition, people who violated certain laws for the first time in some areas can avoid imprisonment by attending special schools.<sup>179</sup> Another example is Pfizer, a vaccine company with high sales during the COVID-19 pandemic. Pfizer is a repeat and "habitual offender" of violating various laws and has been accused of criminal conduct many times, such as unlawful drug marketing strategies and offering bribes to doctors.<sup>180</sup> As violations in this area rise, the government's overall financial penalties for pharmaceutical companies such as Pfizer have significantly increased

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<sup>178</sup> 15 U.S.C. § 45(m)(1)(B) ("If the Commission determines in a proceeding under subsection (b) that any act or practice is unfair or deceptive, and issues a final cease and desist order, other than a consent order, with respect to such act or practice, then the Commission may commence a civil action to obtain a civil penalty in a district court of the United States against any person, partnership, or corporation which engages in such act or practice").

<sup>179</sup> Brittany Glas, 'John School' Would Offer Education Over Jail Time for Soliciting Sex, KXAN (Dec. 16, 2016, 03:06 PM CST), <https://www.kxan.com/news/john-school-would-offer-education-over-jail-time-for-soliciting-sex/> [<https://perma.cc/BK99-PACP>].

<sup>180</sup> Robert G. Evans, *Tough on Crime? Pfizer and the CIHR*, 5 HEALTHCARE POL'Y 16–25 (2010), <https://www.ncbi.nlm.nih.gov/pmc/articles/PMC2875889/> [<https://perma.cc/8XZJ-K4AX>]; Radha Chitale, *Pfizer Pays \$2.3B, but Will It Change the Pharmaceutical Industry?*, ABC NEWS (Sept. 2, 2009, 3:31 PM), <https://abcnews.go.com/Health/PainManagement/pfizers-23-billion-settlement-change-practices/story?id=8476391#:~:text=Without%20Higher%20Penalties%2C%20the%20Industry,and%20what%20they%20don't.> [<https://perma.cc/6JTM-QBSL>].

compared with twenty years ago.<sup>181</sup> The highest settlement fee was as high as \$2.3 billion in 2009.<sup>182</sup> From an economic point of view, it is not difficult to understand why Pfizer has been doing things prohibited by law. Pfizer might have long regarded fines as a part of the corporation's operating costs. If the profit can be guaranteed after paying the fines, the pharmaceutical enterprises might not comply with the law.<sup>183</sup> Similarly, the law hopes to deter directors through fines to avoid violations of the duty of care, which may evolve into directors measuring whether they can afford a fine. The standard proposed in this paper can avoid or reduce this situation substantially.

Another advantage of the proposed method is that it can not only leave room for directors' mistakes but also help the director to keep alert at all times. Under this approach, the applied conditions for directors who breach the duty of care for the first time can be reduced and only bear the responsibility in the case of gross negligence. These directors are held to a lower threshold. The directors who violate the duty of care more than once should meet higher requirements and be liable for general negligence. The specific types of liability can include requiring directors to compensate for the company's losses or removing directors from office.

The corresponding judicial interpretation which has a strong guiding significance for Chinese courts should give detailed guidance to the implementation process of the standard of duty of care. For example, it should advocate that courts should pay more attention to the process of directors' decision-making and supervision rather than whether directors' behavior causes actual losses to the

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<sup>181</sup> See, e.g., Sammy Almashat, Charles Preston, Timothy Waterman & Sidney Wolfe, *Rapidly Increasing Criminal and Civil Monetary Penalties Against the Pharmaceutical Industry: 1991 to 2010*, <https://www.citizen.org/wp-content/uploads/migration/rapidlyincreasingcriminalandcivilpenalties.pdf> [<https://perma.cc/5CG4-T6EE>] (“Over the past two decades, especially during the past 10 years, there has been a marked increase in both the number of government settlements with pharmaceutical companies and the size of the accompanying financial penalties.”); Sammy Almashat, Ryan Lang, Sidney M. Wolfe & Michael Carome, *Twenty-Seven Years of Pharmaceutical Industry Criminal and Civil Penalties: 1991 Through 2017*, <https://www.citizen.org/wp-content/uploads/2408.pdf> [<https://perma.cc/EK52-XQJM>].

<sup>182</sup> Gardiner Harris, *Pfizer Pays \$2.3 Billion to Settle Marketing Case*, N.Y. TIMES (Sept. 2, 2009), <https://www.nytimes.com/2009/09/03/business/03health.html#:~:text=WASHINGTON%20%E2%80%94%20The%20pharmaceutical%20giant%20Pfizer,fine%20of%20any%20kind%20ever.>

<sup>183</sup> Mark A. Lemley & Bryan Casey, *Remedies for Robots*, 86 U. CHI. L. REV. 1311, 1345–46 (2019) (“[T]he choice of whether or not to violate the law depends on the willingness of the lawbreaker to accept the penalty.”).

company or affects the corporation's original acquisition plan.<sup>184</sup> Because it is hindsight biased to believe that directors should have foreseen the consequences of different decisions. Specifically, the court should pay attention to whether the board of directors took the initiative to fully understand the potential benefits and costs of each choice closely related to business decision-making, conduct reasonable research or consult professionals, and determine whether each director had a meaningful discussion or debate on which option to choose. The new round of Chinese Company Law amendments should clarify the standard of duty of care and establish clear norms and objectives for directors to perform their duties. The sooner China formulates explicit norms and objectives for directors to perform their duties, the sooner better corporate governance can be achieved.

## 2. Monetary Liability—Does Chinese Law Need to Provide an Equivalent to the DGCL 102(b)(7) Safe Harbor?

The purpose of substantive law is to decide which party prevails in the lawsuit, while the goal of remedies law is what the winning party can get.<sup>185</sup> Plaintiffs may not take the time to file a lawsuit, incurring litigation and attorney's fees, if it is unlikely that they get due compensation. Therefore, mandatory monetary accountability is the key to making the Chinese version of the duty of care more meaningful.<sup>186</sup> This means that China should not allow provisions like 102(b)(7), otherwise the duty of care will lose its practical role in restricting the behavior of directors. Some directors may only obey the duty of care's requirements when their failure to comply with the duty of care may cause financial losses.<sup>187</sup> The fact is that it is not difficult to hold negligent directors responsible. The problem for legislators and legal scholars is how to let the directors bear the responsibility fairly and reasonably,<sup>188</sup> while also encouraging bold decisions.

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<sup>184</sup> See Velasco, *supra* note 67, at 664 (defending that the duty of care should be process orientated in decision-making procedures); Brehm v. Eisner, 746 A.2d 244, 264 (Del. 2000).

<sup>185</sup> Lemley & Casey, *supra* note 183, at 1314.

<sup>186</sup> To be clear, the compensation for breach of duty of care in corporate law is meant to protect the interests of shareholders and the company from the abuse of directors, not to compensate the victims as in tort law.

<sup>187</sup> Danielle Keats Citron & Daniel J. Solove, *Privacy Harms*, 102 B.U. L. REV. 793, 820 (2022) (articulating the content of deterrence and its positive effect on reducing actions that violate the law).

<sup>188</sup> See Danielle D'Onfro, *Corporate Stewardship*, 44 J. CORP. L. 439, 466 (2019) (indicating that "the more challenging question [to compliance] is how to make that punishment fair").

The results of China's duty of care cases are more varied than Delaware's because Delaware courts attach more importance to the protection of directors' decisions than Chinese courts. In cases where directors need to indemnify the corporation, the proportion of compensation ranges from 10% to 100%. For example, a director who failed to fulfill his duty of care bore 10% of the corporation's loss in *Inner Mongolia*.<sup>189</sup> One of Guangdong's courts ruled that the defendant director was responsible for 40% of the corporation's loss.<sup>190</sup> There are also courts that require directors to compensate for all losses of the company.<sup>191</sup>

The consequences of making directors liable for monetary liability for the breach of duty of care may include: "overprecaution, refusals of good people to serve, demands for increased insurance, indemnification rights, and compensation for the residual risks."<sup>192</sup> However, 102(b)(7) was made in a hurry, so a scholar has suggested that it should stipulate the upper limit of monetary liability to avoid directors who behave badly.<sup>193</sup> Monetary compensation can be reduced for outside

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<sup>189</sup> *Neimenggu Zhongrongrongye Youxian Gongsi Yu Zhangxilun Sunhai Gongsiliyizeren Jiufenshangsu An* (内蒙古中绒绒业有限公司与张希伦损害公司利益责任纠纷上诉案) [Inner Mongolia Zhongrong Cashmere Co. v. Zhang], Inner Mongolia Xingan League Interm. People's Ct. No. 237 (June 5, 2017) ("Considering the actual situation at that time, it is appropriate for [the director] to bear 10% of the loss of Zhongrong company, that is, RMB 395,214.").

<sup>190</sup> *Liu Zijian, Huang Zhijiang Sunhaigongsiliyizerenjiufen An* (刘子健、黄志江损害公司利益责任纠纷案) [Liu v. Huang], Foshan Interm. People's Ct. No.490 (Apr. 8, 2019).

<sup>191</sup> *See, e.g., Xia Chen, Zhu Aiguo Sunhaigongsiliyizerenjiufen An* (夏晨、朱爱国损害公司利益责任纠纷案) [Xia v. Zhu], Hefei Interm. People's Ct. No. 2601 (Sept. 18, 2018).

<sup>192</sup> *See Donald C. Langevoort, The Human Nature of Corporate Boards: Law, Norms, and the Unintended Consequences of Independence and Accountability*, 89 GEO. L.J. 797, 818 (2001). For example, if the court supports the plaintiffs' claim in Disney, directors have to pay \$130 million. *In re Walt Disney Co.*, 900 A.2d at 35.

<sup>193</sup> Elizabeth A. Nowicki, *Director Inattention and Director Protection under Delaware General Corporation Law Section 102(b)(7): A Proposal for Legislative Reform*, 33 DEL. J. CORP. L. 695, 708, 712 (2008). Nowicki suggests changing article 102(b)(7) to the following text:

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



directors such as independent directors, affiliated outside directors, and gray directors' decision-making mistakes.<sup>194</sup> For example, the compensation of internal directors such as executive directors can be 1.25 times that of external directors for decision-making wrongdoings. Because the salary of external directors is less than that of internal directors, the punishment should also be differentiated. Otherwise, for example, after the case of Kangmei pharmaceutical, a lot of independent directors resigned, and no one is willing to act as external directors.<sup>195</sup> The damages caused by the gross negligence and inattention of all categories' directors in the course of performance of duties should not be reduced. By contrast, whether a director has successfully fulfilled the non-decision-making duties such as attending the board meetings or fulfilling the duty to monitor is easily measured by the court. The advantage of separating these two situations is that the injured party can be compensated and the possibility of reducing the enthusiasm of directors to participate in future decisions can be minimized.<sup>196</sup>

At the same time, punishing the director's gross negligence and inattention can have a deterrent effect on other directors, prevent potential violations of the corporate law in advance, and motivate boards to engage in corporate governance. Therefore, the potential penalty or supervision will make people complete their tasks in a higher quality manner than people who are not in the same circumstances.<sup>197</sup>

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*Id.*

<sup>194</sup> Gray directors are directors who are associated with the corporation, but not involved in the details of management, such as relatives of inside directors and investors of the company. For a fuller explanation, see Joel Houston, Jongsub Lee & Hongyu Shan, *Shades of Gray in Board Independence*, THE CLS BLUE SKY BLOG (Oct. 20, 2016), <https://clsbluesky.law.columbia.edu/2016/10/20/the-shades-of-gray-in-board-independence/#:~:text=Gray%20directors%20are%20non%2Dexecutive,either%20independent%20or%20executive%20directors> [<https://perma.cc/CFR3-3L33>].

<sup>195</sup> Bloomberg News, *A \$391 Million Fine Has China's Board Members Quitting En Masse*, BLOOMBERG (Nov. 21, 2021, 8:39 PM PST), <https://www.bloomberg.com/news/articles/2021-11-22/a-391-million-fine-has-china-s-board-members-quitting-en-masse> [<https://perma.cc/X5H2-YBD2>]; Yong Wang (王涌), *Dulidongshi De Dangze Yu Keze* (独立董事的当责与苛责) [Accountability and Liability of Independent Directors], *ZHONGGUO FALV PINGLUN* (中国法律评论) [CHINA LAW REVIEW] 64, 64 (2022).

<sup>196</sup> See *Function Over Form*, *supra* note 53, at 895 (2001) (critically evaluating the benefits of reducing the fiduciary standard of review).

<sup>197</sup> Nowicki, *supra* note 193, at 703 n.19 (citing James Andreoni, William Harbaugh & Lise Vesterlund, *The Carrot or the Stick: Rewards, Punishments, and Cooperation*, 93 AM. ECON. REV. 893, 894 (2003) (proving that A would choose to give B more money when A is told that B may punish themselves for providing too little money, and penalty is more effective than bonus, by designing an experiment where A must split money with B)).

However, it is not practical or desirable to compensate for the loss beyond the directors' actual solvency. The rationale is that strict punishment that is too strict or even occasionally harsh may make judges too cautious. It may even lead judges to possibly avoid noticing where directors can be punished because the high penalty could lead to the repeat of a bad ending similar to *Van Gorkom*, which will greatly frustrate directors' willingness to engage in useful risk-taking<sup>198</sup> or just deter talented directors from taking up directorships in the first place. Thus, the compensation limit can be stipulated. For example, the amount of compensation payable by the directors shall not exceed 15% of the actual loss of the company.<sup>199</sup> Such a limitation would not only give the duty of care substantive significance but would also play a role in the actual supervision of directors and prevent directors from bearing too much pressure. The details of compensation should be listed in detail by item, which can include illegal income in the process of violating the duty of care and fines to compensate plaintiffs. As applied, the judgment would also damage the reputation of directors or cause them to lose their positions, so it is important to provide effective deterrence that encourages directors to fulfill their duties. A large amount of compensation to the corporation from the at-fault director is not the purpose of the duty of care. The correct attitude should be to properly investigate the responsibility of directors, and to a certain extent, to tolerate their mistakes. The court should pay more attention to whether the directors have actively tried to perform the duty of care and whether their attitude towards the duty of care is correct, rather than only focusing on whether the directors have fulfilled the duty of care in a comprehensive way. In addition, the compensation and insurance to negligent directors should be

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<sup>198</sup> See Johnson, *supra* note 54, at 828–29 (1999) (describing the entire care proposal, which is the care of ordinary, reasonable prudence).

<sup>199</sup> For example, Virginia law stipulates the maximum amount of directors' monetary liability: VA. CODE ANN. §§ 13.1–692.1 (2021). Limitation on liability of officers and directors; exception:

- A. In any proceeding brought by or in the right of a corporation or brought by or on behalf of shareholders of the corporation, the damages assessed against an officer or director arising out of a single transaction, occurrence or course of conduct shall not exceed the lesser of:
  1. The monetary amount, including the elimination of liability, specified in the articles of incorporation or, if approved by the shareholders, in the bylaws as a limitation on or elimination of the liability of the officer or director; or
  2. The greater of (i) \$100,000 or (ii) the amount of cash compensation received by the officer or director from the corporation during the 12 months immediately preceding the act or omission for which liability was imposed.

Nowicki, *supra* note 193, at 713.

limited.<sup>200</sup> Otherwise, the directors may not pay attention to the duty of care to the greatest extent, because they would consider that there is always a third party to help them pay for the monetary loss and the potential consequences of failing to perform the duty of care will be minimized due to the existence of insurance.<sup>201</sup>

### 3. Judicial Commentary

In cases considering the duty of care, judicial opinions should not only explain whether the corporate actors involved violated the corporate law or how the directors should be punished for their violation, but they should also employ pedagogical and judicial remedies to deter bad behavior going forward.<sup>202</sup> The Delaware cases provide detailed guidance on how directors perform their fiduciary duty. For example, *Guth v. Loft* advocates directors actively protect corporations' interests and not cause harm to the corporation at the same time.<sup>203</sup> According to the proposal of this Article, the directors will not be punished when they violate the duty of care for the first time, the educational and potential disciplinary function of the detailed reasoning judgment is particularly important in these scenarios. The media always pays attention to the news of large corporations. After reading the comprehensive reasoning in the judgment, the reporters can influence the reputation of the directors through news reports. It may make it difficult for a director with a damaged reputation to find the next job, so the potential punishment from the detailed judgment is not necessarily lower than the direct monetary fine.

However, these functions of judicial commentary have not been effectively utilized and demonstrated in the Chinese version of the duty of care. Chinese court commentary has too little reasoning on judicial review standards of the duty of care, and most cases just apply the provisions directly. Regardless of the outcome or the extent that which damages are imposed, the court's opinion should clearly explain

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<sup>200</sup> The premium is likely to rise in the future or affect the insurance's obtainability. See D'Onfro, *supra* note 188, at 467–68 (2019); see also Nowicki, *supra* note 193, at 715.

<sup>201</sup> Danielle Keats Citron & Daniel J. Solove, *Privacy Harms*, 102 B.U. L. REV. 793, 821 (2022) (“When the magnitude of the defendant’s insurance premiums does not track the magnitude of the defendant’s liabilities, the threat of liability may fall short of promoting optimal deterrence because the defendant can externalize the risk of liability through the purchase of insurance.”); see also Nowicki, *supra* note 193, at 715.

<sup>202</sup> See, e.g., Coffee, *supra* note 143, at 798 (describing the duty of care’s educational role on directors); see also Miller, *supra* note 77, at 327.

<sup>203</sup> *Guth v. Loft, Inc.*, 5 A.2d 503, 510 (Del. 1939) (“[A] corporate officer or director, . . . , not only affirmatively to protect the interests of the corporation committed to his charge, but also to refrain from doing anything that would work injury to the corporation.”).

what the directors should do and what are best practices, so as to provide clear guidance for the directors to regulate their own behaviors.<sup>204</sup>

If the court does not write detailed judicial dicta, especially in the absence of a unified and specific review standard, it would be difficult for directors to know what the limitation of directors' behavior is. For example, it may not be clear what degree of care can be tolerated by law or what action will touch the red line of the law. The detailed explanation of legal documents will also help to encourage directors to take the initiative to strictly align their own behavior with higher standards, thus decreasing the risk of damage to the interests of the corporation.

#### IV. CONCLUSION

Most of the corporate laws of common law systems and civil law systems countries set up the concept of duty of care. The application of the duty of care in various countries can allow countries and corporations to learn from each other, which is conducive to the development of corporate law itself. America's dichotomy of the standard of conduct and standard of review and gross negligence standards weakens the importance of duty of care. The U.S. should pay attention to the possible consequences of this issue and therefore change how academic scholars and practitioners only focus on the duty of loyalty and ignore the duty of care. The improvement measures that the U.S. may take include, but are not limited to, narrowing the gap between MBCA 8.30 and 8.31. The experience of the U.S. provides valuable governance principles for the establishment of China's duty of care standard. Chinese courts can choose which standard to adopt according to whether the director has a violation record or not. Unified standards will make the trial results of different cases more coherent and consistent and reduce the appeal rate to a certain extent. In addition, more discretion should be given to judges in judicial practice, and more detailed case analyses should be encouraged.

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<sup>204</sup> See, e.g., Melvin A. Eisenberg, *Corporate Law and Social Norms*, 99 COLUM. L. REV. 1253, 1270 (1999).

