HOW A “SUPERSTAR” CEO EXPOSES THE NECESSITY FOR THIRD PARTY D&O INSURANCE

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I. INTRODUCTION

The influence that “superstar” CEOs have over a company’s board of directors can be alarming. Take Elon Musk—for better or worse, Elon has become the gift that keeps on giving for corporate and securities law professors. Among other things, Elon’s ability to skirt personal liability for seemingly obvious breaches of duty has raised concerns within the realm of corporate governance and corporate regulation. While much has been written about Elon’s influence on Tesla’s board of directors, one area of the law that often gets overlooked that has exacerbated Elon’s corporate governance issues is that of directors and officers (“D&O”) liability insurance.

In April 2020, Tesla decided to not renew its D&O insurance; in its place, Elon, the CEO, Chairman, and a board member of Tesla, offered to personally insure the board members. The decision not to renew was due to what Tesla claimed as “disproportionately high premiums quoted by insurance companies.”[1] This came on the heels of Elon tweeting about “[f]unding secured” to take Tesla private,[2] which ultimately resulted in Security and Exchange Commission (“SEC”) sanctions and related ongoing litigation. Were Tesla’s “disproportionately

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1. Tesla, Inc., Annual Report (Form 10-K/A) (Apr. 28, 2020).

2. Elon Musk (@elonmusk), TWITTER (Aug. 7, 2018, 9:48 AM), https://twitter.com/elonmusk/status/1026872652290379776?lang=en.

high premiums" a result of Elon's increasingly erratic behavior and misconduct? Likely. The continuing failure of the board to demonstrate any ability to control him? Possibly. The move ultimately represented the board's inability to effectively monitor the company's CEO, which is a fundamental duty under corporate law.

The decision by Elon to personally insure board members, while not unprecedented,[3] is exceedingly rare. It underscored the notion of the "captured" board at Tesla and raised additional criticisms about the effectiveness and independence of Tesla's board.[4] While personally insuring board members seems like a very "Elon" move, it could have broader implications beyond Elon. Are "superstar" CEOs above the law? What are the effects on corporate law? How can we safeguard accountability of fiduciary duties?

This Article proceeds in four parts. Part II narrates the behavior of Elon as the CEO, Chairman, and a director of Tesla, which led to several lawsuits and SEC sanctions. Undoubtedly, his behavior and the resulting litigation had an impact on Tesla's D&O insurance rates, leading Tesla to forgo traditional ways of insuring and resulting in Elon personally insuring the directors. Part III discusses a staple of corporate law—fiduciary duties owed by the board and officers to the company—and highlights the fact that directors are required to put the interests of the company, and shareholders, above the interest of themselves and the interest of the CEO if any conflict arises. Part IV discusses the significance of D&O insurance and the role it plays for corporate fiduciaries. Part V elaborates on the concerns and potential consequences of Tesla-Elon-type D&O agreements on the structure of corporate governance and corporate law.

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3. *See* Kevin LaCroix, *In Lieu of D&O Insurance, Musk Agrees to Provide Tesla with "Coverage,"* D&O DIARY (Apr. 28, 2020), https://www.dandodiary.com/2020/04/articles/d-o-insurance/in-lieu-of-do-insurance-musk-agrees-to-provide-tesla-with-coverage/ (Kevin provides a recount of a similar arrangement where a bank did not carry D&O insurance and instead, the bank's founder, chairman, and largest shareholder personally provided indemnification).

4. For a comprehensive overview of the background and problems with a captured board, see generally Kobi Kastiel & Yaron Nili, *"Captured Boards": The Rise of "Super Directors" and the Case for a Board Suite*, 2017 WIS. L. REV. 19 (2017). *See also* Gregory Shill, *The Independent Board as Shield*, 77 WASH. & LEE L. REV. 1811 (2020) (outlining the reasons that a robust corporate governance structure requires independent board members).

II. THE CONSEQUENCES OF ERRATIC TWEETS

In 2013, Tesla encouraged investors to review Musk's tweets and notified the market that it intended Elon's Twitter account to be a means of announcing material information about Tesla.[5] While the SEC requires certain information to be disclosed in Tesla's SEC filings, Tesla has no oversight in terms of disclosure controls or procedures to determine when Elon's tweets contained information that required disclosure.[6] Ultimately, Elon's tweets and what accounted to "material" enough to require disclosure became a heated debate, leading to SEC sanctions and years of litigation. This Part outlines Elon's behavior and resulting SEC sanctions and litigation.

A. "Funding Secured"

Elon is well known for going off the cuff on Twitter, which has often resulted in him getting "in trouble."[7] However, his Twitter activity on August 7, 2018, led to over four and half years of litigation. The tweet? "Am considering taking Tesla private at $420. Funding secured."[8]

5. Press Release, U.S. Sec. & Exch. Comm'n, Elon Musk Settles SEC Fraud Charges; Tesla Charged with and Resolves Securities Law Charge (Sept. 29, 2018), https://www.sec.gov/news/press-release/2018-226 [hereinafter Press Release SEC].

6. *Id.*

7. Elon's tweets, even before he purchased the platform, have long been noted for their candid and controversial nature. *See, e.g.*, Jordan Valinsky, *Elon Musk Tweets Support for 'Dilbert' Creator After Racist Tirade*, CNN BUS. (Feb. 27, 2023, 10:18 AM), https://edition.cnn.com/2023/02/27/business/elon-musk-scott-adams-defense/index.html (reporting that Elon Musk defended a well-known cartoonist's racist comments).

8. Elon Musk (@elonmusk), TWITTER (Aug. 7, 2018, 9:48 AM), https://twitter.com/elonmusk/status/1026872652290379776?lang=en.

Just a few hours later he posted another tweet: "Investor support is confirmed. Only reason why this is not certain is that it's contingent on a shareholder vote."[9]

The price of Tesla stock jumped immediately after Elon posted these tweets, and subsequently declined precipitously when the proposed deal fell apart less than three weeks later.[10]

B. The Making of a "Twitter Sitter"

The tweets led to the SEC filing a complaint against Elon and Tesla.[11] The SEC's complaint against Elon alleged securities fraud under Section 10(b) of the 1934 Securities Exchange Act and Rule 10b-5.[12] Section 10(b) and the attendant Rule 10b-5 are the basis for nearly every securities fraud action brought by the SEC.

In order for the SEC to be successful in pursuing an action under Section 10(b) and Rule 10b-5, it must show that the defendant knew, or was at least reckless in not knowing, the falsity or misleading nature of a material statement.[13] Section

9. Elon Musk (@elonmusk), TWITTER (Aug. 7, 2018, 12:36 PM), https://twitter.com/elonmusk/status/1026914941004001280?lang=en.

10. Kalley Huang & Peter Eavis, *Jury Rules for Elon Musk and Tesla in Investor Lawsuit Over Tweets*, N.Y. TIMES (Feb. 3, 2023), https://www.nytimes.com/2023/02/03/business/elon-musk-tesla-investor-trial.html?searchResultPosition=1.

11. Complaint at 1, U.S. Sec. & Exch. Comm'n v. Musk, 2018 WL 4659481 (S.D.N.Y. Sept. 27, 2018) (No. 1:18-cv-8865) [hereinafter Complaint].

12. 15 U.S.C. § 78j(b); 17 C.F.R. § 240.10b-5 (2022). In contrast, the complaint against Tesla alleged a violation of Rule 13a-15, 17 C.F.R. § 240.13a-15, which involved a violation of internal controls and procedures to ensure compliance with securities laws.

13. Section 10(b) states, in relevant part:

10(b) and Rule 10b-5 align with the greater scheme of securities laws, in that they seek to regulate and mandate certain disclosure by firms that sell securities.[14] Section 10(b) and Rule 10b-5 prohibit disclosure of false or misleading information, and that information has to be material.

Neither Congress, the SEC, nor the Supreme Court defined "material information" until 1976, when the Court resolved the issue in *TSC Industries v. Northway, Inc*.[15] Specifically, the Court held that a material fact is one that "would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."[16] This was generally understood to include information that significantly affected a company's financial performance and consequently translated into stock market gains or losses.

In 1988, the Supreme Court reaffirmed this materiality standard in *Basic Inc. v. Levinson* and unanimously held that a bright-line rule regarding what information is considered

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—
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> . . .
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> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, or any securities-based swap agreement any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. § 78j(b).

Likewise, Rule 10b-5 states:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
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> **(a)** To employ any device, scheme, or artifice to defraud,
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> **(b)** To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
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> **(c)** To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5.

14. *See, e.g.*, Karen E. Woody, *Conflict Minerals Legislation: The SEC's New Role as Diplomatic and Humanitarian Watchdog*, 81 FORDHAM L. REV. 1315, 1322–24 (2012) (explaining the importance of materiality in a disclosure-based securities law regime).

15. 426 U.S. 438 (1976).

16. *Id.* at 449.

material is inappropriate and unnecessary.[17] The Court in *Basic* held that materiality is "about what is important to investors, nothing more and nothing less."[18] In other words, the *Basic* Court held that a fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote in a corporate election.[19] The Court applied the "probability times magnitude test" for estimating when speculative or forward-looking information is sufficiently important to rise to the level of "material."[20]

According to the SEC's complaint, Elon's August 7, 2018, tweet regarding taking Tesla private at $420 per share with funding secured was material, false, and misleading.[21] In truth, according to the SEC, Elon "knew that the potential transaction was uncertain and subject to numerous contingencies."[22] Further, the SEC alleged that Elon's false and "misleading tweets caused Tesla's stock price to jump by over six percent on August 7, and led to significant market disruption."[23]

The SEC's complaint against Tesla alleged that despite notifying the market in 2013 that Elon's Twitter account would be used to announce material information regarding Tesla and encouraging investors to review Elon's tweets, Tesla had no sufficient process in place to ensure Elon's tweets were accurate.[24] Moreover, Tesla had no disclosure controls or procedures in place to determine if the information contained in Elon's tweets would require disclosure in Tesla's SEC filings.[25]

Elon and Tesla, without admitting or denying the allegations, settled with the SEC.[26] The settlement required Elon to step down as Tesla's Chairman for three years,[27] for Tesla to

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17. 485 U.S. 224, 249 (1988).
18. Donald C. Langevoort, *Basic at Twenty: Rethinking Fraud on the Market*, 2009 WIS. L. REV. 151, 152 (2009); *see also Basic*, 485 U.S. at 240.
19. *Basic*, 485 U.S. at 240.
20. *Id.* at 238 (citing SEC v. Tex. Gulf Sulphur Co., 401 F.2d 833, 849 (2d Cir. 1968)).
21. Complaint, *supra* note 11, at 2; *see also* Press Release SEC, *supra* note 5.
22. Press Release SEC, *supra* note 5. Musk had not discussed specific deal terms, including price, with any potential financing partners, and his statements about the possible transaction lacked an adequate basis in fact. *Id.*
23. *Id.*
24. *Id.*
25. *Id.*
26. *Id.*
27. *Id.*

appoint additional independent directors, and for Tesla and Elon to pay $40 million in penalties, $20 million each.[28] Further, Elon and Tesla agreed to establish a board committee to set controls and provide oversight of Elon's public communications about Tesla.[29] Per the settlement, Elon was required to seek "pre-approval of any such written communications that contain, or reasonably could contain, information material to the Company or its shareholders."[30] In other words, Elon was assigned a "Twitter sitter" and was required to seek approval from a designated in-house lawyer prior to posting a tweet that could be considered "material."[31]

However, this was not the last Elon or Tesla would see of those tweets or the settlement. In August 2018, a class action was filed against Elon and Tesla in the Northern District of California.[32] In October and November 2018, five derivative lawsuits were filed in the Delaware Court of Chancery against Elon and the members of Tesla's board of directors in relation to the August 7 tweets.[33] These lawsuits were stayed pending resolution of the class-action lawsuit.[34]

C. Breach of SEC Settlement

As predicted, Elon did not stop tweeting material information regarding Tesla. Moreover, he failed to seek approval of his tweets. On February 19, 2019, just five months following the SEC settlement, Elon tweeted that Tesla would "make

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28. *Id.*; Consent Motion for Entry of Final Judgment at 1, *U.S. Sec. & Exch. Comm'n v. Musk*, (S.D.N.Y. 2018) (No. 1:18-cv-8865-AJN-GWG) [hereinafter Consent Motion for Entry of Final Judgment]; *see also* Mathew Goldstein, *Elon Musk Steps Down as Chairman in Deal with S.E.C. Over Tweet About Tesla*, N.Y. TIMES (Sept. 29, 2018), https://www.nytimes.com/2018/09/29/business/tesla-musk-sec-settlement.html.

29. Goldstein, *supra* note 28.

30. Consent Motion for Entry of Final Judgment, *supra* note 28, at 5.

31. Rohan Goswami & Lora Kolodny, *Elon Musk Still Needs 'Twitter Sitter' Judges Rule*, CNBC (May 15, 2023, 1:46 PM), https://www.cnbc.com/2023/05/15/elon-must-still-needs-twitter-sitter-judge-rules.html.

32. *In re* Tesla, Inc. Sec. Litig., 477 F. Supp. 3d 903 (N.D. Cal. 2020); *see also* Tesla, Inc., Annual Report (Form 10-K) (Feb. 19, 2019).

33. Tesla, Inc., Annual Report (Form 10-K) (Feb. 19, 2019).

34. *Id.*

around 500k"[35] cars in 2019, contradicting Tesla's official guidance of 360,000 to 400,000 cars in 2019.[36]

The tweet led to the SEC filing a motion to hold Elon in contempt for violating the settlement.[37] According to the SEC, Elon failed to seek approval for the tweet as required under the agreement.[38] However, Elon argued that he only needed to seek approval when his tweets contained "material" information, and he was free to determine whether his tweets were material or not.[39] Ultimately, this led to the SEC settlement being amended to include specific oversight, requiring Tesla's securities lawyer to preapprove any public, written communication containing any of the following information:

- Tesla's financial condition, statements, or results, including earnings or guidance
- potential or proposed mergers, acquisitions, dispositions, tender offers, or joint ventures

35. Elon Musk (@elonmusk), TWITTER (Feb. 19, 2019, 4:15 PM), https://twitter.com/elonmusk/status/1098013283372589056?lang=en.

36. *See* Neal E. Boudette, *Tesla's Record Deliveries Aren't Enough for Investors*, N.Y. TIMES (Nov. 13, 2019), https://www.nytimes.com/2019/10/02/business/tesla-sales.html (reporting that Tesla forecasted that in 2019, it would sell 360,000 to 400,000 cars); *see also* Neal E. Boudette, *Tesla Reports Profit for Quarter, Sending Shares Soaring*, N.Y. TIMES (Nov. 13, 2019), https://www.nytimes.com/2019/10/23/business/tesla-earnings.html (reporting that in 2019 Tesla forecasted that it would sell 360,000 to 400,000 cars, and explaining that to meet Elon's goal, Tesla will have to sell another 105,000 cars by the end of the year).

37. Neal E. Boudette, *S.E.C. Asks Court to Hold Tesla's Elon Musk in Contempt for Twitter Post on Production*, N.Y. TIMES (Feb. 25, 2019), https://www.nytimes.com/2019/02/25/business/elon-musk-contempt-tweet-sec-tesla.html.

38. *Id.*

39. Sean O'Kane, *Elon Musk Says the SEC's Attempt to Hold Him in Contempt is 'Virtually Wrong at Every Level,'* THE VERGE (Mar. 22, 2019, 7:04 PM), https://www.theverge.com/2019/3/22/18277919/elon-musk-sec-court-contempt-twitter.

- production, sales, or delivery numbers (actual or estimated) that haven't been shared, or ones that differ from Tesla's official guidance
- new or proposed lines of business unrelated to Tesla's existing businesses (defined in the filing as "vehicles, transportation, and sustainable energy products[“])
- changes in the status of Tesla's securities, credit facilities, or financing / lending arrangements
- nonpublic legal or regulatory findings or decisions
- anything that would require the filing of an 8-K form with the SEC, including changes in control of the company, or to its executive officers and directors
- any other topic that Tesla — or a majority of its independent members of the company's board of directors — believe needs pre-approval[40]As anticipated, Elon did not stop posting erratic tweets. A lawsuit filed in March 2021 alleged that Elon violated his fiduciary duty to Tesla by continuing to post "erratic" tweets in violation of the SEC settlement, and that the board violated their fiduciary duties owed to the company.[41]

Among the complaint's cited tweets was a post from May 1, 2020, where Elon suggested Tesla's shares were overvalued.[42] Specifically, he posted: "Tesla stock price is too high imo [in my opinion]."[43]

40. Sean O'Kane, *The Court Has Approved Elon Musk's New Agreement to Let Lawyers Oversee His Tesla Tweets*, THE VERGE (Apr. 30, 2019, 7:30 PM), https://www.theverge.com/2019/4/26/18484751/elon-musk-sec-fraud-tesla-tweets-contempt-agreement.

41. Verified Stockholder Derivative Complaint ¶¶ 35, 205, Gharrity v. Musk, 2021 WL 1037353 (Del. Ch. Mar. 8, 2021) (No. 2021-0199-JRS) [hereinafter Verified Stockholder Derivative Complaint].

42. *Id.* ¶ 29.

43. Elon Musk (@elonmusk), TWITTER (May 1, 2020, 8:11 AM), https://twitter.com/elonmusk/status/1256239815256797184?lang=en.

Additionally, the March 2021 complaint contained something particularly interesting; the plaintiff alleged that the "Board cannot be considered independent in any way from Musk," as he personally insured the Board.[44] And in fact, that is exactly what happened: Elon agreed to personally insure Tesla's board of directors.

D. The Tesla-Elon Agreement

When Tesla decided not to renew its D&O insurance policy in April 2020, it was replaced with a promise by Elon to personally provide the board members with "substantially equivalent" coverage to what insurers would provide.[45] According to the Tesla Annual Report 2019 10-K:

> Tesla determined not to renew its directors and officers liability insurance policy for the 2019-2020 year due to disproportionately high premiums quoted by insurance companies.[46] Instead, Elon Musk agreed with Tesla to personally provide coverage substantially equivalent to such a policy for a one-year period, and the other members of the Board are third-party beneficiaries thereof. The Board concluded that because such arrangement is governed by a binding agreement with Tesla as to which Mr. Musk does not have unilateral discretion to perform, and is intended to replace an ordinary course insurance policy, it would not impair the independent judgment of the other members of the Board.[47]

This agreement was extremely controversial. D&O insurance indemnifies directors and officers from potential personal liability they may incur from their service on the board.[48] Under the agreement, each of the directors relied on Elon to cover any company or board members' costs for legal defenses, settlements,

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44. Verified Stockholder Derivative Complaint, *supra* note 41, ¶ 254.
45. Tesla, Inc., Annual Report (Form 10-K/A) (Apr. 28, 2020).
46. The Stockholder Complaint blamed the "disproportionately high premiums quoted by insurance companies" on Elon's behavior and the Board's response, or rather lack thereof. The Complaint also inferred that Tesla's legal troubles in the preceding year and the concern about future claims "almost certainly exacerbated the situation." Verified Stockholder Derivative Complaint, *supra* note 41, ¶ 90.
47. Tesla, Inc., Annual Report (Form 10-K/A) (Apr. 28, 2020).
48. See *infra* pt. III for an in-depth explanation of D&O insurance.

or judgments against them. To understand the full implication of the agreement, we need to examine the staple of corporate law—fiduciary duties—and D&O's role in those fiduciary duties.

III. THE STAPLE OF CORPORATE LAW: FIDUCIARY DUTIES

To uphold a primary principle of corporate governance, boards need to maintain a degree of independence in order to put the interests of the company first. Thus, a staple of corporate law is that both officers and directors of corporations owe fiduciary duties to the corporation itself—accordingly, they are termed corporate fiduciaries.[49] As a general rule, corporate fiduciaries have two broad fiduciary duties: the duty of care and the duty of loyalty.[50]

A. Duty of Care and its Requirement of Oversight

The duty of care, at a minimum, requires a director to exercise reasonable "care, skill, prudence, and diligence" when making business decisions.[51] The corporate fiduciary must take reasonable care to inform him or herself of the basic nature of the business, including its financial circumstances.[52] It also includes a duty of oversight, often referred to as *Caremark* duties,[53]

49. Denise M. Alter, *Corporate Art Collecting and Fiduciary Duties to Shareholders: Legal Duties and Best Practices for Directors and Officers*, 2009 COLUM. BUS. L. REV. 1, 7 (2009); *see, e.g.*, Miller v. McDonald (*In re* World Health Alts., Inc.), 385 B.R. 576, 592–93 (Bankr. D. Del. 2008) (discussing how the *Caremark* decision itself suggests that officers owe the same fiduciary duties as directors to the corporation and shareholders).

50. Ellen Taylor, *New and Unjustified Restrictions on Delaware Directors' Authority*, 21 DEL. J. CORP. L. 837, 879–83 (1996) (noting that "[d]irectors owe duties of loyalty, good faith, and care to the corporation and its shareholders" and outlining what each of these duties require).

51. *See* Fifth Third Bancorp v. Dudenhoeffer, 573 U.S. 409, 415 (2014) (reasoning that the "prudent man standard of care" controls the fiduciary duty of care standard in that the fiduciary must act with "the care, skill, prudence and diligence under the circumstances then prevailing"); *see also* Roberta Romano, *Corporate Governance in the Aftermath of the Insurance Crisis*, 39 EMORY L.J. 1155, 1156 (1990).

52. *See* Francis v. United Jersey Bank, 432 A.2d 814, 821–22 (1981).

53. Dubbed after one of Delaware's most significant duty of care cases. *See In re* Caremark Int'l Inc. Derivative Litig., 698 A.2d 959 (Del. Ch. 1996), *adopted by* Stone v. Ritter, 911 A.2d 362, 365 (Del. 2006).

requiring the fiduciary to inquire into particular problems the corporation might have where it is reasonable to do so.[54]

In re Caremark International Inc. Derivative Litigation,[55] a 1996 decision penned by the Delaware Court of Chancery, enshrined the business judgment rule in Delaware law, and underscored the principle that directors will not be held liable absent evidence of their bad faith.[56] In *Caremark,* the defendant company, Caremark International, was involved in a kickback scheme related to Medicare and Medicaid payments in exchange for doctor referrals.[57] The firm eventually had to pay a landmark settlement to both federal and state regulators, as well as over $85 million in restitution.[58] As a result, plaintiff-shareholders filed a number of derivative lawsuits, claiming that the firm's "directors allowed a situation to develop and continue which exposed the corporation to enormous legal liability and that in so doing they violated a duty to be active monitors of corporate performance."[59] Chancellor Allen nevertheless held that a "director's obligation includes a duty to attempt in good faith to assure that a corporate information and reporting system, which the board concludes is adequate, exists."[60] The court added that a "failure to do so under some circumstances may, in theory at least, render a director liable for losses caused by non-compliance with applicable legal standards."[61]

In order to survive a motion to dismiss when pursing a *Caremark* claim, plaintiffs must show (1) directors failed to establish a system to monitor and evaluate corporate compliance, and (2) even if directors did establish such a system, they ignored the red flags presented or caught by the compliance system. *Caremark*, for almost three decades, has set a minimum standard, or a baseline requirement that directors must satisfy to

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54. *See id.*
55. *See infra* pt. IV for an overview of derivative lawsuits.
56. *Caremark*, 698 A.2d at 967–69; *see also* Angela A. Aneiros & Karen E. Woody, Caremark*'s Butterfly Effect*, 72 AM. U. L. REV. 719, 723 (2022).
57. *Caremark*, 698 A.2d at 962–64.
58. Ronald E. Yates, *Caremark Wounds Not Deep*, CHI. TRIB. (June 19, 1995, 12:00 AM), https://www.chicagotribune.com/news/ct-xpm-1995-06-19-9506190063-story.html.
59. *Caremark*, 698 A.2d at 967.
60. *Id.* at 970.
61. *Id.*

demonstrate their fulfillment of their duties.[62] This *Caremark* standard for compliance has consistently been defined as more than just mere inaction, indicating that is does not assess its effectiveness.[63]

Because *Caremark* was an opinion by the Delaware Court of the Chancery, it was largely advisory regarding the board's duty to monitor. In fact, the Delaware Supreme Court did not weigh in on the issue for over a decade, and ultimately decided *Stone v. Ritter* in 2006.[64] *Stone*, which was a derivative lawsuit against Directors of AmSouth Bancorporation (AmSouth), involved plaintiff-shareholders suing following a government investigation that resulted in AmSouth and a subsidiary paying $50 million in fines and penalties for failures to file Suspicious Activity Reports as required by the Bank Secrecy Act and anti-money laundering regulations.[65] However, the court found that because the AmSouth directors neither "knew nor should have known that violations of law were occurring," there were no "red flags."[66] The *Stone* court held that the Directors had met their *Caremark* obligations, finding they had "discharged their oversight responsibility to establish an information and reporting system."[67]

What exactly does "monitoring" a system of compliance entail, and what exactly are "red flags"? Since *Stone*, there have only been a handful of derivative suits demanding personal liability for board members pursuant to *Caremark* that have cleared the motion to dismiss stage.[68] Nonetheless, these recent

62. Aneiros & Woody, *supra* note 56, at 724 & n.27 (citing Guttman v. Huang, 823 A.2d 492, 493–94, 505–06 (Del. Ch. 2003)) ("explaining that pursuing a *Caremark* claim is demanding because it requires particularized facts 'showing that the directors were conscious of the fact that they were not doing their jobs,' with the particularized facts typically only arising in the specific case of a sustained or systematic failure of the board to exercise oversight").

63. *Id.* at 724.

64. 911 A.2d 362 (Del. 2006).

65. *Id.* at 365.

66. *Id.* at 364.

67. *Id.* at 371–72.

68. The five relevant cases are the following: Marchand v. Barnhill, 212 A.3d 805 (Del. 2019); *In Re* Clovis Oncology, Inc. Derivative Litig., No. 2017-0222-JRS, 2019 WL 4850188, at *1 (Del. Ch. Oct. 1, 2019); Hughes *ex rel.* Kandi Techs. Grp., Inc. v. Xiaoming Hu, No. 2019-0112-JTL, 2020 WL 1987029, at *1 (Del. Ch. Apr. 27, 2020); Teamsters Loc. 443 Health Servs. & Ins. Plan v. Chou, No. 2019-0816-SG, 2020 WL 5028065, at *1–2 (Del. Ch. Aug. 24, 2020); *In re* Boeing Co. Derivative Litig., No. 2019-0907-MTZ, 2021 WL

decisions have shed light on the meaning of the *Caremark* standard.

Taken as a whole, the five important post-*Caremark* decisions that have cleared the motion to dismiss stage provide important criteria for directors and officers. First, directors and officers in highly regulated industries are particularly at risk if they fail to become apprised of the "mission critical" risks pertinent to the company. For example, in the case of *Boeing*, the court allowed the plaintiff-shareholders claim to survive a motion to dismiss because there was no evidence that the Boeing directors discussed airplane safety or heeded any warnings about potential issues with their flagship 737 MAX aircraft.[69]

Second, directors and officers serving companies that are "monoline," meaning they have one singular product, must keep apprised of potential risks. This is because there is an inherent pressure for the board to overlook certain risks given that the success of the company could rise and fall based upon the singular product's effectiveness. The pertinent examples of this are Bluebell Ice Cream, which faced a listeria outbreak that resulted in the death of over four people,[70] and Clovis Oncology, which falsified the results of certain clinical trials because it had only one particular drug available for market.[71] Finally, directors and officers in companies in any and all industries must be mindful to question the information provided from management, and to do their own investigation and due diligence if any red flags are raised. The court in each of the five post-*Caremark* cases remarked upon the tendency of the board to take management at its word without performing any additional inquiry or investigation, and this was fodder for a breach of care claim.

4059934 at *1 (Del. Ch. Sept. 7, 2021). For a full discussion on each case, see Aneiros & Woody, *supra* note 56.

69. *Boeing*, 2021 WL 4059934, at *1; *see also* David Slotnick, *The Second Boeing 737 Max Crash Happened a Year Ago, Here's What Went Down, the Unanswered Questions, and the Ongoing Fallout*, BUS. INSIDER (Mar. 10, 2020, 12:12 PM), https://www.businessinsider.com/boeing-737-max-ethiopian-airlines-302-crash-year-2020-3.

70. *See Marchand*, 212 A.3d at 807.

71. *See Clovis Oncology*, 2019 WL 4850188 at *1.

B. The Duty of Loyalty

As for the duty of loyalty—it essentially requires that the fiduciary take all actions relevant to their official capacity with undivided loyalty to the corporation.[72] This means that the fiduciary violates the duty of loyalty where one acts with a conflict of interest.[73] A conflict of interest exists in basically two situations: an interested transaction or a usurpation of a corporate opportunity.[74] Sometimes, a fiduciary has some personal interest in a particular transaction that is different than the corporation's best interests.[75] For example, where a corporate fiduciary has a personal financial interest in the transaction.[76] The corporate fiduciary can also have a conflict where they have a fiduciary to both parties in a transaction, which would be the case, for example, if the individual is on the board of directors of two different corporations that are negotiating a deal with one another.[77] Additionally, the duty of loyalty is implicated when a corporate fiduciary takes what we call a corporate opportunity.[78]

72. *See* Alter, *supra* note 49, at 8 n.18 noting the duty of loyalty involves "avoiding acting in a self-interested manner to the corporation's detriment."

73. *See* Julian Velasco, *The Diminishing Duty of Loyalty*, 75 WASH. & LEE L. REV 1035, 1037 (2018) ("The duty of loyalty is concerned with conflicts of interest. Directors are expected to act in the interests of the corporation and its shareholders, rather than in their own interests.").

74. The interested transaction category of duty of loyalty cases "aris[es] out of transactions between the corporation and its controlling stockholder." *In re* Wheelabrator Techs., Inc. S'holders Litig., 663 A.2d 1194, 1203 (Del. Ch. 1995). The "usurpation of corporate opportunity" is also known as the corporate opportunity doctrine, which prohibits officers or directors from taking business opportunities for his or her own if the opportunity meets a four-pronged test devised in Guth v. Loft, Inc., 5 A.2d 503, 509 (Del. Ch. 1939). Broz v. Cellular Info. Sys., Inc., 673 A.2d 148, 155 (Del. 1996).

75. Reis v. Hazelett Strip-Casting Corp., 28 A.3d 442, 458 (Del. Ch. 2011) ("Directors and managers . . . may depart from the best interests of the corporation and its shareholders due to a variety of non-pecuniary, but equally selfish, motivations.").

76. *See* Rales v. Blasband, 634 A.2d 927, 936 (Del. 1993) ("A director is considered interested where he or she will receive a personal financial benefit from a transaction that is not equally shared by the stockholders.").

77. *See Broz*, 673 A.2d at 151 (stating that the defendant in this case was both a president and sole stockholder of one company, while serving as a director of another company).

78. *See id.* at 154–55 ("The corporate opportunity doctrine, as delineated by *Guth* and its progeny, holds that a corporate officer or director may not take a business opportunity for his own if: (1) the corporation is financially able to exploit the opportunity; (2) the opportunity is within the corporation's line of business; (3) the corporation has an interest or expectancy in the opportunity; and (4) by taking the opportunity for his own, the corporate fiduciary will thereby be placed in a position inimicable to his duties to the corporation."). However, the mere presence of a conflict does not mean that the fiduciary

In the simplest sense, this is when a corporate fiduciary discovers an opportunity that the corporation would undertake, but the corporate fiduciary takes it for himself.

C. The Derivative Suit

In order to clarify the importance of a derivative lawsuit, some background on derivative lawsuits is instructive. What is a derivative lawsuit?

Often, the company itself is harmed by the board and officers' breach of fiduciary duties. Who should be held liable for this harm? Arguably, the board members and officers who breached their fiduciary duties should be held liable to the company. However, responsibility for bringing a claim on behalf of the company lies with the board and officers.[79] It is therefore unlikely the board or officers would bring a claim against themselves. As such, a mechanism has been created for shareholders to stand in the shoes of the company: derivative lawsuits.

Unlike a direct claim, a derivative suit is not brought for the benefit of the shareholder herself. In a derivative lawsuit, a shareholder can bring a lawsuit on *behalf* of the company naming its board and officers as defendants.[80] Here, the plaintiff-

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has breached his or her duties. It merely means that if the fiduciary is sued for breach of those duties, the fiduciary must show fairness. For duty of loyalty claims, where the fiduciary's decision-making process is at issue, Delaware courts use three tiers: the business judgment rule, enhanced scrutiny, and entire fairness. *In re* Trados Inc. S'holder Litig., 73 A.3d 17, 43 (Del. Ch. 2013). The entire fairness standard is one of Delaware's "most onerous [and] applies when the board labors under actual conflicts of interest. Once entire fairness applies, the defendants must establish . . . 'that the transaction was the product of both fair dealing and fair price.'" *Id.* at 44 (quoting Cinerama, Inc. v. Technicolor, Inc. (Technicolor III) 663 A.2d 1156, 1163 (Del. 1995)). Further complex series of consequences can follow if the conflicted of interest transaction is ratified by a disinterested majority of either the board of directors or the shareholders. *See Wheelabrator Techs.*, 663 A.2d at 1196, 1201 (where the shareholder vote on the merger was fully informed); *see also* Smith v. Van Gorkom, 488 A.2d 858, 889 (Del. 1985) (holding that a "merger can be sustained, notwithstanding the infirmity of the Board's action, if its approval by majority vote of the shareholders is found to have been based on an informed electorate"). Further, there are many mechanisms and laws in place to limit the personal liability of directors and officers for breaches of fiduciary duties.

79. Hughes *ex rel.* Kandi Techs. Grp., Inc. v. Xiaoming Hu, No. 2019-0112-JTL, 2020 WL 1987029, at *9 (Del. Ch. Apr. 27, 2020); *see also* DEL. CODE ANN. tit. 8, § 141(a) (2020).

80. *See* Jessica Erickson, *Corporate Misconduct and the Perfect Storm of Shareholder Litigation*, 84 NOTRE DAME L. REV. 75, 81 (2008) (noting how the shareholder may receive an indirect benefit from the suit based on their share in the company but will not receive a direct financial benefit, making the suit derivative rather than direct); David W. Locascio, Comment, *The Dilemma of the Double Derivative Suit*, 83 NW. U. L. REV. 729, 729 (1989).

shareholder must allege the company was harmed by the directors' or officers' breach of fiduciary duties.[81] Derivative suits provide an individual shareholder the ability to bring suit to enforce a corporate cause of action against the board and officers in order to obtain restitution.[82]

A derivative suit is virtually the only mechanism for holding management accountable for its wrongs against the company. Any monetary damages awarded to the plaintiff-shareholder in a derivative suit are paid to the corporation, not the individual shareholder. This difference is significant for several reasons, particularly because of a director's indemnification rights. Under a derivative suit, amounts paid in a settlement or judgment typically cannot be reimbursed. Consequently, a director's risk exposure in derivative suits can be extremely high. Fortunately for directors and officers, derivative suits are not easy cases for a plaintiff to bring.

In order to bring a derivative lawsuit, the plaintiff-shareholder must demonstrate a right to stand "in the company's shoes."[83] Because the power to make decisions for the company lies with the board, courts have significantly restricted shareholders' ability to proceed with a derivative suit, creating very high pleading standards. For this reason, knowing the process to bring a derivative lawsuit is critical to understand how much the deck is stacked against plaintiffs in this process.

81. Erickson, *supra* note 80; *see also* Aronson v. Lewis, 473 A.2d 805, 811 (Del. 1984), *overruled by* Brehm v. Eisner, 746 A.2d 244 (Del. 2000); Ross v. Bernhard, 396 U.S. 531, 534 (1970) (stating how derivative suits permit an individual shareholder to bring suit to "enforce a *corporate* cause of action against officers, directors, and third parties").

82. *See* Kamen v. Kemper Fin. Servs., Inc., 500 U.S. 90, 95 (1991) ("[T]he purpose of the derivative action [is] to place in the hands of the individual shareholder a means to protect the interests of the corporation from the misfeasance and malfeasance of 'faithless directors and managers.'") (quoting Cohen v. Beneficial Loan Corp., 337 U.S. 541, 548 (1949)). Shareholder derivative suits have long been recognized as a way for shareholders to hold directors and officers accountable for misconduct.

83. *Ross*, 396 U.S. at 534–35 (explaining that stockholders cannot ordinarily sue directors, but that stockholders can bring a derivative lawsuit on the corporation's behalf when the claim is one on which the corporation could have sued and when the directors refused a demand for action).

1. The Derivative Lawsuit High Pleadings Requirement

Among the high pleading requirements, the most essential pre-filing requirement is the "demand requirement."[84] Rule 23.1 of the Federal Rules of Civil Procedure states in relevant part:

> The complaint [in a shareholder derivative action] must . . . state with particularity: (A) any effort by the plaintiff to obtain the desired action from the directors or comparable authority and, if necessary, from the shareholders or members; and (B) the reasons for not obtaining the action or not making the effort.[85]

A derivative lawsuit, therefore, requires a plaintiff-shareholder to (1) specifically plead the plaintiff-shareholder made a pre-suit demand on the board, which the board wrongfully refused, or (2) explain the reason for not making the required demand.[86]

2. The Demand Requirement and Business Judgment Rule

In order to fulfill the demand requirement, the plaintiff-shareholder must be able to show a "demand" to redress the alleged harm done to the company was made on the board or officers. Once a demand is made, the board's refusal of the demand is "subject only to the deferential 'business judgment rule' standard of review."[87] The business judgment rule "is 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."[88] Not only is a board's refusal of a litigation demand subject to the business judgment rule, but the board's actions and decisions that predicate the allegations are also subject to the

84. Lucian Arye Bebchuk et al., *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751, 780 (2002).

85. FED. R. CIV. P. 23.1(b)(3).

86. *Id.*

87. *Kamen*, 500 U.S. at 101 (citing Zapata Corp. v. Maldonado, 430 A.2d 779, 784 & n.10 (Del. 1981)).

88. Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) (citing Kaplan v. Centex Corp., 284 A.2d 119, 124 (Del. Ch. 1971)).

business judgment rule.[89] In other words, when directors and officers make poor business decisions, those decisions do not create automatic liability for shareholders' losses. Instead, directors and officers are given the wide berth of the business judgment rule to make business decisions without fear of legal liability.[90]

The board's decisions, including refusing shareholder demands, are therefore presumed valid unless the plaintiff-shareholder can rebut the presumption.[91] The burden is on the plaintiff to rebut the presumption by presenting evidence that at the time of making the decision-in-question, the directors were grossly negligent in not becoming adequately informed, not acting in the best interest of the company, or acting in bad faith.[92] This can be extremely difficult for shareholders to accomplish at the pleading stage because very little, if any, discovery has been conducted. Consequently, the business judgment rule has historically safeguarded directors and officers, and the majority of derivative suits are dismissed at the pleading stage.

However, shareholder derivative suits have long been recognized as a way for shareholders to hold directors and officers accountable for misconduct:

> a stockholder is not powerless to challenge director action which results in harm to the corporation. The machinery of corporate democracy and the derivative suit are potent tools to redress the conduct of a torpid or unfaithful management. The derivative action developed in equity to enable shareholders to sue in the corporation's name where those in control of the company refused to assert a claim belonging to it.[93]

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89. Daniel J. Morrissey, *The Path of Corporate Law: Of Options Backdating, Derivative Suits, and the Business Judgment Rule*, 86 OR. L. REV. 973, 997–1000 (2007) (discussing the demand requirement as well as its justification).

90. Lyman Johnson, *Unsettledness in Delaware Corporate Law: Business Judgment Rule, Corporate Purpose*, 38 DEL. J. CORP. L. 405, 411 (2013) (quoting Parnes v. Bally Ent. Corp., 722 A.2d 1243, 1246 (Del. 1999)).

91. *Kamen*, 500 U.S. 90, 101 (1991) (citing *Zapata*, 430 A.2d at 784 & n.10).

92. *In re* Walt Disney Co. Derivative Litig., 906 A.2d 27, 52 (Del. 2006) (outlining the three categories of "bad faith" behavior by fiduciaries under Delaware law that can rebut the presumption of the business judgment rule: (a) subjective bad faith, (b) a lack of due care, and (c) intentional dereliction of duty).

93. *Aronson*, 473 A.2d at 811 (explaining the importance of the ability for shareholders to bring derivative suits in promoting fairness and justice in corporate law).

It is important to note that many states prohibit a corporation from indemnifying an officer or director if they are found personally liable to the corporation for a breach of duty of care or loyalty.[94] This is where D&O insurance steps in—it safeguards directors' and officers' personal assets when found liable to the company.[95]

IV. D&O INSURANCE'S ROLE IN FIDUCIARY DUTIES

As we have seen an increase in the number of derivative lawsuits in recent years,[96] D&O insurance has become increasingly important.[97] This Part discusses the significance of D&O insurance for officers and directors, as well as corporations.

In order to protect the board of directors and officers against legal liability arising out of their role with the corporation, D&O liability insurance is purchased by the corporation.[98] D&O insurance protects (1) the directors and officers from having to pay personal assets when they are found personally liable for something; and (2) the assets of the corporation.[99] Typically, the protections for the corporations, directors, and officers are secured by insuring under the three core agreements of D&O insurance: Side A, Side B, and Side C, or "A-B-C" coverage.[100]

For officers and directors, Side A is the most important part of the policy—it acts as professional liability insurance for covered individuals, providing reimbursement for damages,

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94. *See* Robert A. Johnson, *Delaware Prohibits Indemnification of Costs for Settling a Derivative Suit, but the Rules in Other States May Differ*, 14 NO. 14 ANDREWS CORP. OFFICERS & DIRS. LIAB. LITIG. REP. 17 (May 24, 1999); *see also, e.g.*, DEL. CODE ANN. tit. 8, § 145(a) (2021) (prohibiting indemnification for settlements and judgments "by or in the right of the corporation").

95. For a detailed discussion of D&O insurance safeguards of officers' and directors' personal assets, see generally Angela N. Aneiros, *The Unlikely Pressure for Accountability: The Insurance Industry's Role in Social Change*, 27 TEX. J.C.L. & C.R. 139, 163–69 (2022). *See also* Business Owner's Playbook, *The Who, What & Why of Directors & Officers Insurance*, THE HARTFORD, https://perma.cc/MK5Q-UV8A (last visited July 21, 2023) (outlining the specifics of D&O coverage).

96. For a discussion on the recent increase in duty to monitor claims see generally Aneiros & Woody, *supra* note 56, at 724.

97. *See generally id. See also* Tom Baker & Sean J. Griffith, *The Missing Monitor in Corporate Governance: The Directors' & Officers' Liability Insurer*, 95 GEO. L.J. 1795, 1801 (2007).

98. Baker & Griffith, *supra* note 97, at 1801.

99. *See id.* at 1797; *see also* Business Owner's Playbook, *supra* note 95.

100. Aneiros, *supra* note 95, at 164.

settlements, judgments, and defense costs as a result of a legal action.[101] For these reasons, Side A is called the "personal protection" part of the policy. Importantly, it protects the assets of an individual director or officer for claims the company cannot or will not indemnify the individual.[102] Historically, Side A coverage would apply when a corporation was insolvent, and therefore could not indemnify the board or officers.[103] However, many states have indemnification statutes that prohibit a company from indemnifying directors and officers for any settlement portion of a derivative claim.[104]

Side B reimburses a company for its indemnification obligation to its directors and officers. While state indemnification statutes prohibit indemnification in certain situations, they also typically contain mandatory and permissive indemnification provisions.[105] For example, while Delaware law prohibits indemnification for judgments or settlements in actions against a director of officer claiming liability to the corporation, it *permits* indemnification for defense costs.[106] The mandatory indemnification provisions "create[] an enforceable right, *requiring* the corporation to indemnify its directors and officers upon satisfaction of certain statutory prerequisites."[107] Again turning to Delaware's indemnification statute, it *requires* a corporation to indemnify its directors and officers for any "expenses (including attorneys' fees) actually and reasonably incurred" in defending a lawsuit, "to the extent" of the director's or officer's success "on the merits or otherwise."[108]

101. *See Understanding the Many Facets of Side A D&O (DIC)*, GB&A INS., https://www.gbainsurance.com/facets_side_a_dic_918 (last visited June 1, 2023) (noting that a D&O policy "provides first dollar coverage"). D&O can extend to defense costs as a result of criminal and regulatory investigations, but it typically does not cover intentional illegal acts. *Id.*

102. Julia Kagan, *Directors and Officers (D&O) Liability Insurance: What Is It, Who Needs It?*, INVESTOPEDIA (July 10, 2022), https://www.investopedia.com/terms/d/directors-and-officers-liability-insurance.asp.

103. Baker & Griffith, *supra* note 97, at 1802–03.

104. *See, e.g.*, DEL. CODE ANN. tit. 8, § 145(a) (2022) (prohibiting indemnification for settlements and judgments "by or in the right of the corporation").

105. Robert P. McKinney, *Protecting Corporate Directors and Officers: Indemnification*, 40 VAND. L. REV. 737, 738 (1987).

106. DEL. CODE ANN. tit. 8, § 145(b).

107. McKinney, *supra* note 105, at 738 (emphasis added).

108. DEL. CODE ANN. tit. 8, § 145(c) (providing that "[t]o the extent that a . . . director or officer of a corporation has been successful on the merits or otherwise in defense of any

Side B insurance would reimburse the company under these circumstances.

The "entity coverage" part of the policy is under Side C. Side C ensures the corporation is covered when the corporation is also named in the lawsuit.[109] While Side C provides private companies with broad entity coverage, it only covers security claims for public companies.[110]

As evident by the coverages describe above, D&O insurance "protect[s] a company's directors and officers in times of crisis and catastrophe."[111] Thus, an expansive and robust D&O insurance policy reduces fears of being personally liable for a liability claim.[112] It is this reason that D&O insurance has played an incentivizing role in attracting and retaining top talent for outside directors and officers.[113]

V. IMPLICATIONS TO CORPORATE LAW

D&O insurance is not often considered when discussing the staples of corporate law. However, as the safeguard for officers and directors, D&O insurance is intrinsically tied to fiduciary duties. The inability of the company to indemnify directors and officers is significant. For example, Delaware law states in relevant part, "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."[114] For these reasons,

action, suit or proceeding . . . [he] shall be indemnified against expenses (including attorneys' fees) actually and reasonably incurred by . . . [him] in connection therewith").

109. Kagan, *supra* note 1022; Baker & Griffith, *supra* note 97, at 1802.

110. *See Directors and Officers Liability (D&O)*, MARSH, https://www.marsh.com/us/services/financial-professional-liability/directors-and-officers-liability.html (last visited July 21, 2023).

111. *See* LaCroix, *supra* note 3.

112. *See* René Otto & Wim Weterings, *D&O Insurance and Corporate Governance: Is D&O Insurance Indicative of the Quality of Corporate Governance in a Company?*, 24 STAN. J.L. BUS. & FIN. 105, 108 (2019).

113. *See id.* at 108 (citing Tom Baker & Sean J. Griffith, *Predicting Corporate Governance Risk: Evidence from the Directors' & Officers' Liability Insurance Market*, 74 U. CHI. L. REV. 487, 502 (2007)); *see also* Noel O'Sullivan, *Insuring the Agents: The Role of Directors' & Officers' Insurance in Corporate Governance*, 64 J. RISK & INS. 545, 549 (1997).

114. DEL. CODE ANN. tit. 8, § 145(b) (2022). Further, under Delaware law, directors and officers may be exculpated for any breach of care if included in the articles of incorporation. *Id.* § 145(c).

Side A coverage has become increasingly more important to directors and officers.

A. Tesla-Elon Side A Coverage

The Tesla-Elon Agreement appears to provide only "Side A" coverage. According to Tesla, "[p]ursuant to the indemnification agreement, our CEO provided, from his personal funds, directors' and officers' indemnity coverage to us during the interim term **in the event such coverage is not indemnifiable by us**, up to a total of $100 million."[115] Thus, Elon would, in theory, indemnify the directors and officers when the corporation *could not* indemnify them. As previously explained, this would be in a situation where directors or officers are found liable to the corporation.

B. Tesla-Elon Agreement's Potential Breach

The Tesla board clearly anticipated public concern over the Tesla-Elon agreement and attempted to eradicate them in their Annual Report:

> The Board concluded that because such arrangement is governed by a binding agreement with Tesla as to which Mr. Musk does not have unilateral discretion to perform, and is intended to replace an ordinary course insurance policy, **it would not impair the independent judgment of the other members of the Board**.[116]

In this statement, the board was attempting to give notice that their business judgment would not be influenced by the Tesla-Elon agreement.

However, not everyone took the board's disclosure at face value. As argued by shareholders in the March 2021 complaint, the agreement made it impossible for the board to be "considered independent in any way from Musk."[117] Among other things:

115. Tesla, Inc., Quarterly Report (Form 10-Q) (Sept. 30, 2020) (emphasis added).
116. Tesla, Inc., Annual Report (Form 10-K/A) (Apr. 28, 2020) (emphasis added).
117. Verified Stockholder Derivative Complaint, *supra* note 41, ¶ 254.

> [Elon] controls whether the directors and officers of Tesla are insured for, among other things, failing to oversee his misconduct, the terms on which they settle any litigation, whether they settle any litigation, or whether those directors and officers have to reach into their own pockets should they be accused of any wrongdoing.[118]

Recall the fiduciary duties of officers and directors—the duty of care and the duty of loyalty. The duty of care requires a director to exercise the degree of diligence, care, and skill that an ordinarily prudent person would exercise under similar circumstances. This includes a continuing duty to stay informed to the extent reasonably believed appropriate and the duty of oversight. The duty of loyalty requires the directors to place the interests of the company and the shareholders before any of their personal interests. Luckily for directors and officers, they are entitled to protection of the business judgment rule if their business judgment is made in good faith and is (1) not self-interested (in other words, not a conflict of interest that would fall under the duty of loyalty); (2) informed to the extent reasonably appropriate (duty of oversight); and (3) rationally believed to be in the best interest of the corporation.[119]

1. The Threat to the Duty of Care

Tesla's decision to not renew the D&O policy would ordinarily be considered a business decision, and would fall under the duty of care, which would be protected by the business judgment rule. A judge would not second-guess the directors' business decision. It would be assumed that the directors made the decision to not renew the D&O insurance, and instead entered an agreement with Elon personally on an informed basis, in good faith, and in the honest belief that the decision was in the

118. *Id.* ¶ 90.

119. *See In re* Trados Inc. S'holder Litig., 73 A.3d 17, 43 (Del. Ch. 2013) (quoting Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) ("The [business judgment] rule presumes 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.'")).

best interest of the company. However, a plaintiff may rebut that presumption by showing the board is not independent.[120]

As the University of Delaware Professor Charles Elson noted:

> I don't think that it was advisable for the chief executive officer of the company to indemnify the company and directors. It linked the directors too closely to the CEO because of that relationship. The CEO is an individual over whom the board has authority. And such a linkage would make it more difficult for board members to exercise good oversight on behalf of all shareholders.[121]

Oversight is one of the requirements that falls under the duty of care. The duty of oversight requires directors (and now officers) to (1) make a good faith effort to ensure the corporation has implemented a proper reporting system, and (2) appropriately address "red flags" of corporate wrongdoing.[122]

Consider the following hypothetical. Imagine that a situation involving sexual harassment, similar to Activision[123] or McDonalds,[124] emerged at Tesla against Elon. Imagine that the allegations are well-founded and corroborated by evidence. The claim is serious enough that the board must consider whether Elon's employment as CEO must be terminated. Maybe the allegations are so serious that shareholders demand the corporation take action and sue Elon.

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120. *See* Orman v. Cullman, 794 A.2d 5, 22 (Del. Ch. 2002) (explaining that for the plaintiff to overcome the presumption set by the business judgment rule, and thus allow the court to use stricter standard of entire fairness in evaluating the breach of fiduciary duty claim(s), the plaintiff must plead facts demonstrating that the directors or officers are blatantly interested, or conflicted).

121. Lora Kolodny, *Tesla Paid CEO Elon Musk $3 Million to Provide Indemnity for Directors and Officers Against Legal Claims*, CNBC (Oct. 27, 2020, 2:24 PM), https://www.cnbc.com/2020/10/26/tesla-paid-elon-musk-millions-for-90-days-indemnification-insurance.html.

122. *See supra* pt. III and accompanying notes.

123. *See, e.g.*, Amanda Silberling, *Activision Blizzard is Once Again Being Sued for Sexual Harassment,* TECHCRUNCH (Oct. 13, 2022, 4:17 PM), https://techcrunch.com/2022/10/13/activision-blizzard-is-once-again-being-sued-for-sexual-harassment/.

124. *See, e.g.*, Press Release, Equal Opportunity Emp. Comm'n, McDonald's Franchise to Pay Nearly $2 Million to Settle EEOC Sexual Harassment Lawsuit (Jan. 6, 2023), https://www.eeoc.gov/newsroom/mcdonalds-franchise-pay-nearly-2-million-settle-eeoc-sexual-harassment-lawsuit.

In such a situation, how would the insurance-agreement with Elon impact the board's decisions? The board is aware of the situation and is faced with a decision to fire Elon or not. The decision needs to be made in good faith and in the best interest of the company. Option A: the board does not fire Elon. It is possible a shareholder makes a demand on the board to fire Elon and they refuse. The plaintiff brings a derivative action against Elon and the other directors claiming they wrongfully refused. Here, the board's refusal of the demand would be subject to the deferential business judgment rule's standard of review and presumed valid, unless the plaintiff can rebut the presumption.[125] The plaintiff could rebut the presumption by showing that the majority of the board is not sufficiently independent or disinterested to exercise valid business judgment.[126]

Alternatively, Option B: it is possible a shareholder would not make a demand on the board and rather, bring a derivative claim against Elon and the other directors alleging demand futility. The plaintiff-shareholder would then need to allege with particularity that there was a reasonable doubt the board was capable of making an independent decision.[127]

During the entire litigation period, the board would be dependent on Elon for indemnification if the suit was not dismissed. If the suit were dismissed, the company would pay the entire cost of litigation without any assistance of insurance. The board has authority over Elon, but he has control of their ability to be indemnified. Would this not all play a part in the decision whether to terminate Elon?

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125. *Orman*, 794 A.2d at 22.

126. However, "sufficiently independent" is a somewhat vague term. As noted in Valesco's article, conflicts that at first glance seem like they would cause the director's or officer's independence to be jeopardized, are actually insufficient under the entire fairness test to trigger a duty of loyalty claim. *See* Julian Velasco, *The Fundamental Rights of the Shareholder*, 40 U.C. DAVIS L. REV. 407, 430 (2006); *see also* Julian Velasco, *Shareholder Ownership and Primacy*, 2010 U. ILL. L. REV. 897, 911, 932 (2010) [hereinafter Velasco, *Shareholder Ownership and Primacy*].

127. *See* United Food & Com. Workers Union v. Zuckerberg, 250 A.3d 862, 890 (Del. Ch. 2020), *aff'd*, 262 A.3d 1034 (Del. 2021) (clarifying the demand futility requirement that plaintiffs must meet in order to bring a derivative action).

2. Duty of Loyalty Perils

There is a clear path in which the board and officers would not receive the business judgment deference—if the plaintiffs alleged a breach of duty of loyalty. The duty of loyalty imposes the reasonability standard to avoid potential conflicts of interest. As previously explained, a conflict of interest may arise from an "interested transaction." The two common scenarios for a conflict of interest are when a corporate fiduciary has a personal financial interest in a transaction or when a fiduciary is on both sides of a transaction.[128] Under these circumstances, directors cannot rely on the business judgment rule to protect them, and it is the directors' burden of proof to show that the transaction was fair and reasonable at the time.

When a corporate fiduciary is on both sides of a transaction, they are involved in an interested transaction. Here, the transaction is the Tesla and Elon agreement for Elon to personally insure the board. Regarding the agreement, Elon was on both sides of the transaction—he was an officer and director who needed to be insured, as well as the party insuring the officers and directors. In return for Elon's personal indemnification, Tesla disclosed that it "agreed to pay [its] CEO a total of $3 million, which represents the market-based premium for the market quote described above, as prorated for 90 days and further discounted by 50%."[129]

However, not all corporate transactions involving a conflict of interest violate the duty of loyalty.[130] Most states have adopted "safe harbor" statutes to protect officers and directors from

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128. The facts of *Weinberger v. UOP, Inc.* illustrate the type of conflict that may arise when directors were on both sides of the transaction. 457 A.2d 701, 710 (Del. 1983). There, the directors were on the boards of both the corporation and its subsidiary, and the directors attempted to structure a transaction where parent would benefit at the subsidiary's expense. *Id.*; *see also In re* Orchard Enters., Inc. S'holder Litig., 88 A.3d 1, 33 (Del. Ch. 2014) ("A plaintiff can call into question a director's loyalty by showing that the director was interested in the transaction under consideration or not independent of someone who was."); Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 362 (Del. 1993) ("Classic examples of director self-interest in a business transaction involve either a director appearing on both sides of a transaction or a director receiving a personal benefit from a transaction not received by the shareholders generally.").

129. Tesla, Inc., Quarterly Report (Form 10-Q) (Oct. 26, 2020).

130. *See* Velasco, *Shareholder Ownership and Primacy*, *supra* note 126, at 954–55 (stating that not all conflicted transactions will arise to the level that the conflict must be evaluated under the entire fairness standard).

liability when it involves an interested transaction.[131] If a corporate fiduciary is involved in an interested transaction, the transaction may be ratified in a number of ways. Two ways that an interested transaction involving a board member can be ratified are: (1) the material facts of the interested transaction are disclosed or known by the board, and the board in good faith authorizes the transaction by the affirmative votes of a majority of the disinterested directors; or (2) "the material facts as to the director's or officer's relationship or interest and transaction are disclosed or are known to the stockholders entitled to vote thereon, and the transaction is specifically approved in good faith by vote of the stockholders."[132] Further, a transaction that is *fair* to the corporation at the time it is authorized, approved, or ratified by the board or stockholder will not be void per se.

Turning to the first way to ratify—the good faith authorization by the fully informed majority of the disinterested directors. There is no doubt the board in this was fully informed about the nature of the transaction. However, in creating the Tesla-Elon agreement, *none* of the board members were disinterested. Each one of the directors was personally affected by the transaction; each relied on Elon to cover any costs they incurred, including judgments and settlements, if Tesla was unable to indemnify. Therefore, the Tesla-Elon agreement could not be affirmed by a majority of the disinterested board of directors.

As for the second way to ratify—the good faith authorization by the fully informed shareholders—this was impossible. The Tesla-Elon agreement was never put to a vote before the shareholders; it was a decision made only by the board of directors.[133]

131. *See, e.g.*, DEL. CODE ANN. tit. 8, § 102(b)(7) (2022); CAL. CORP. CODE § 204(a)(10) (2022); N.Y. BUS. CORP. LAW § 719(e) (McKinney 2016); TEX. BUS. ORGS. CODE ANN. § 21.418(b) (2011); NEV. REV. STAT. § 78.138.7 (2021); FLA. STAT. § 607.0831 (2023); 805 ILL. COMP. STAT. 5/8.65(c) (2015); GA. CODE ANN. § 14-2-864(c) (2010); MD. CODE ANN., CORPS. & ASS'NS § 2-405.1(e) (2016); N.J. STAT. ANN. § 14A:6-12 (1974); 15 PA. CONS. STAT. § 1735 (2023).

132. DEL. CODE ANN. tit. 8, § 144(a) (2010); *see, e.g.*, Solomon v. Armstrong, 747 A.2d 1098, 1113–16 (Del. Ch. 1999), *aff'd*, 746 A.2d 277 (Del. 2000) (explaining a variety of ways that shareholders may ratify a transaction presented by the directors).

133. *See* Tesla, Inc., Annual Report (Form 10-K/A) (Apr. 28, 2020).

The one avenue for the Tesla-Elon agreement to fall under a safe-harbor would be by showing the agreement was *fair*. This protection does not require disclosure or a disinterested board. Rather, the corporate fiduciary who is involved in the interested transaction bears the burden of proving the transaction was fair procedurally and substantively.[134]

VI. CONCLUSION

Although having a CEO personally insure a board is a rare occurrence, the risks associated with such a decision underscore the importance of having directors and officers prioritize their fiduciary duties to the firm, rather than to the CEO. This Article has outlined the cautionary tale of Elon Musk and detailed the duties of board members to the firm rather than to any individual CEO or any other officer. As we have seen in the case of Elon Musk, the cult of personality CEO often can create problems and conflicts of interests within the firm, and particularly among the board. D&O insurance belongs with independent D&O insurance firms so as to allow a divide among the board members and the CEO and reduce the risk of a captured board. The consequences of ignoring those risks are dire for both the firm and for the individual board members.

134. Put another way, the plaintiff must show that there was a lack of fair dealing and fair price. *See* Weinberger v. UOP, Inc., 457 A.2d 701, 711 (Del. 1983) (stating examples of "fair dealing" and "fair price"). Here, because there was no vote by the shareholders, the burden is on the directors to prove that the transaction was substantively and procedurally fair. *Cf. id.* at 703 (concluding that where a corporate action was approved by an informed vote of the majority of the minority shareholders, the burden shifts to the plaintiff to prove that the transaction was substantively and procedurally unfair).